JOHN BOVAIRD BRENNAN

THE COMPANIES ACT 1993 AND COMMON LAW DIRECTORS' DUTIES TO CREDITORS

The Demise Of Redundant Judicial Sympathies

LLM RESEARCH PAPER
BODIES CORPORATE AND UNINCORPORATE
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CONTENTS

ABSTRACT

This paper examines the obligations company directors may owe to creditors after the advent of the Companies Act 1993 (the "93 Act"). Prior to the 93 Act's enactment, there was a body of anglo-antipodean case law, emanating initially from Australia but endorsed in both New Zealand and the United Kingdom, that prescribed the consideration by directors of the interests of creditors of the company in certain circumstances. Such consideration was often couched in the language of a "duty". Contemporaneously, in New Zealand the Companies Act 1955 (the "55 Act") provided obligations upon directors to refrain from permitting the company to engage in reckless trading and unreasonably incurring debts. These were recognised as obligations for the benefit of a company's creditors. The passing of the 93 Act witnessed the first express statutory formulation of the duties directors owe when engaged in the management of a company. Of relevance to this paper, sections 135 and 136 of the 93 Act place duties upon directors to refrain from permitting their company engaging in activity that is likely to create a substantial risk of loss to the company's creditors or from incurring obligations the company has no reasonable chance of performing when required to do so, respectively. This paper examines the general scope of these new provisions using the previous 55 Act obligations to creditors as the starting point for analysing the provisions' content. A specific enquiry as to the continued relevance of the pre-93 Act anglo-antipodean case law advocating director consideration of creditors' interests is then undertaken.

Part One of the paper introduces the topic. Part Two outlines the traditional conceptions that directors' duties are owed exclusively to the company or, alternatively, the shareholders, before proceeding to examine the judicial comment sympathetic towards the notion that directors may owe a duty to consider the interests of their company's creditors. The part concludes by outlining the parameters of this perceived duty, expressly addressing when the duty arises, to whom is it owed, what it requires of directors, its juridical source, and some of the conceptual difficulties therein.

Part Three of the paper examines the provisions of the 93 Act. It initially explores the relationship between the statutory duties provided in the 93 Act and the considerable body of case law that previously regulated of directors' duties under the 55 Act regime and its

predecessors. It is submitted the pre-93 Act case law on the general nature of directors' duties will still be of considerable relevance to the interpretation of the statutory duties under the 93 Act regime. Next, the duties contained in sections 135 and 136 of the 93 Act are examined and reference is made to substantially similar provisions from the 55 Act. Part Four analyses how the cases which evidenced judicial support for a common law directors' duty in relation to creditors would be treated under the 93 Act regime if they arose today. The part concludes by submitting the case law sympathetic to such a duty is likely to have little, if any, continuing relevance to director conduct under the new regime. The "mischief" of directors at issue in the case law would be typically proscribed by the provisions of the 93 Act, or if not, it is demonstrated the courts in the particular case law were not prepared to hold the directors culpable either.

Finally, Part Five of the paper examines some of the policy issues and theoretical constructs surrounding the imposition of directors' duties aimed at protecting creditors. It is submitted, however, the "pragmatic" approach of the 93 Act is focussing upon the performance of company obligations, as sections 135 and 136 do, is appropriate in light of the fact patterns giving rise to judicial examination of director misconduct.

The text of this paper (excluding contents page, footnotes, bibliography and appendices) comprises approximately words.

The structure of this paper is divided into: "Parts" headed in the centre of the page with each word in capitals identified by capitalised roman numerals; "Sections" headed at the left hand margin with the initial letter of each word capitalised and identified by capitalised letters, e.g., "A", "B", "C", etc; "Subsections" headed at the left hand margin with only the initial letter of the first word of the subsection capitalised and identified by arabic numerals; and finally, "Paragraphs" headed at the left hand margin with no capitalisation of any letters (unless a proper noun or defined term is employed) and identified by lower case letters, e.g., "a", "b", "c", etc.

I INTRODUCTION

The legislation clearly has been framed to try to prevent the directors of a company sheltering behind the limited liability of a company in incurring debts, I do not think that a director must necessarily behave in a way that he would do if it was his own money that was being put at risk, as would be the case if he was incurring debt on his own behalf and not on behalf of the limited liability company... One of the reasons why limited liability companies are permitted is so that a company may trade without being inhibited by the factors that would influence a person acting on his own behalf. Nevertheless, some regard must be had to the fact that directors have a responsibility akin to the responsibility they would have if they were acting for themselves. The section appears to me to be designed to compensate those who have suffered loss as a result of directors' actions without unduly hampering the directors in their operation of a company.[1]

Thus Hillyer J enunciated some of the competing policy considerations at work in an earlier legislative initiative[2] designed to protect those who suffered loss as a result of the actions of directors. More recently, a clearly discernible body of judicial comment sympathetic towards creditors of insolvent companies has become apparent. This sympathy has evidenced itself through a series of cases from English and antipodean jurisdictions purporting to increase directors' duties at common law, duties which have traditionally been viewed as being owed exclusively to the company.[3]

1994 witnessed the enactment of Companies Act 1993 (the "93 Act"). The 93 Act was a landmark upon New Zealand's company law vista, inter alia, for its positive exposition of the duties directors owe at law. No such positive duties had been previously provided in the Companies Act 1955 unamended (the "55 Act"), although that Act did contain some statements, albeit negatively expressed, which imposed liabilities on directors to creditors and minority shareholders (in circumstances of reckless trading[4] and minority oppression,[5] respectively). The obiter dicta sympathetic to creditors' interests is, therefore, but part of the larger volume of complex case law that regulated director behaviour prior to the 93 Act.

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1 *Vinyl Processors (New Zealand) Ltd (in liq)* v *Cant* [1991] 2 NZLR 416; [1991] MCLR 33 ("*Vinyl Processors*") p 428; 45, per Hillyer J.
2 55 Act, section 320.
3 See below Part II Section B Subsection 1 - The orthodox view: exclusively to the company.
4 55 Act, section 320.
5 55 Act, section 209.

Notable amongst the duties prescribed by the 93 Act are the duties to refrain from engaging a company in activity that is likely to create a substantial risk to loss of the company's creditors[6] and from agreeing to the company incurring obligations it has no reasonable chance of performing.[7] This paper essentially investigates the likely scope of those new statutory duties, particularly enquiring what will become of the judicial sympathies supportive of a common law directors' duty regarding creditors with the advent of the 93 Act.

The paper commences by surveying the body of case law prescriptive of an obligation on directors to consider the interests of their company's creditors, before outlining the perceived parameters of this common law duty and some of the conceptual issues involved therein. It then proceeds to examine the 93 Act, including its relationship to the general common law of directors' duties, and the substance of the section 135 and section 136 duties. A comparative analysis of how the fact patterns of the cases propounding support for the common law duty in regard to creditors would be determined under the 93 Act is then undertaken to ascertain the continuing relevance, if any, of the common law duty. Finally, the paper explores some of the policy considerations regarding the concept of directors' duties to creditors at a more abstract level.

6 93 Act, section 135.
7 93 Act, section 136.

II COMMON LAW FORMULATIONS OF DIRECTORS' DUTIES: A DISCRETE DUTY TO CREDITORS?

A Introduction: Trustees, Agents Or Creatures Of Statute?

Directors of companies have traditionally enjoyed broad powers of administration.[8] As a means of controlling directors in the exercise of those powers, the common law devised a set of principles which were collectively termed "directors' duties". The standards of conduct expected of directors by the courts has been said to be both strict and lax, the discrepancy being attributed to the court's need to balance the competing obligations of fettering uncontrolled director discretion and avoiding unnecessarily stifling management via excessive judicial control.[9]

In earlier times it was often stated that directors were trustees and that the nature of their duties could be explained on that basis.[10] However, to describe directors today as trustees is perceived neither to be strictly correct or helpful.[11] Rather, directors are perceived to be agents of the company. As agents, directors are said to be in a fiduciary relationship vis-a-vis the company, their principal.[12] But even clarification as a fiduciary shed little light upon the nature of directors' duties.[13] It is submitted that perhaps the most accurate description of the nature of a director accords with the observation of Lord Russell that directors "are the creatures of statute and occupy a position peculiar to themselves".[14] As a general matter then,

8 J H Farrar and M W Russell *Company Law and Securities Regulation in New Zealand*, Butterworths, Wellington 1985 ("Farrar & Russell") p 223.

9 Farrar & Russell, above n 8, p 223.

10 It is easy to see how this idea arose. Prior to 1844 most joint stock companies were unincorporated and depended for their validity upon a deed of settlement vesting the property of the company in trustees. It was common for the directors to also be the trustees. With the advent of incorporated companies, although the description of "trustee" was less apposite, it was not unnatural for the courts to extend it to them by analogy. First, the duties of directors should have been the same regardless of the incorporation or otherwise of the company, and secondly, equity invariably labelled anyone in a fiduciary position a trustee. See generally, L C B Gower *Gower's Principles of Modern Company Law*, 4th ed, Stevens & Sons, London, 1979 ("Gower"), chapter 24.

11 Gower, above n 10, p 571, where the author cites Romer J in *Re City Equitable Fire Insurance Co* [1925] Ch 407 ("*City Equitable*"), p 426 as authority.

12 L S Sealy "The Director as Trustee" [1967] Camb L J 83, p 86.

13 See Farrar & Russell, above n 8, where the authors quote the comments of Frankfurter J in *Securities and Exchange Commission v Chenery Corporation* 318 US 80 (1943), pp 85-86:

> *But to say a man is a fiduciary only begins the analysis; it gives direction to further inquiry, to whom is he a fiduciary? what obligations does he owe as a fiduciary? in what respects has he failed to discharge these obligations? and, what are the consequences of his deviation from duty?*

14 *Regal Hastings* v *Gulliver* [1942] All ER 378, p 387.

the common law identified several heads under which directors owed duties,[15] although these were admitted not to be exclusive and could overlap.[16] With regard to the general taxonomy of directors' duties, the duties of loyalty and good faith commanded higher standards of directors' behaviour than the lower standards of skill and care expected.[17] Of particular pertinence to this paper, however, is to whom those duties are owed.

B Traditional Conceptions Of To Whom Directors Owe Duties

1 The orthodox view: exclusively to the company

The orthodox and widely accepted conception of directors' duties is that they are owed exclusively to the company as opposed to individual shareholders, for example.[18] This begets enquiry as to what is meant by "the company". One notion suggested by the courts is the "hypothetical individual shareholder".[19] Other conceptions are existing members, future members, and extensions to include creditors, employees or other interest groups.[20] The issue is one not without controversy.[21] In attempting to give meaning to the company as an abstract notion, strength is given to the argument for an identity between the company as a whole and its shareholders, due to the capacity of shareholders to ratify directors' breaches of their duties ex-post. Moreover, the notion that directors' duties are owed exclusively to the company has been controversial for the limitations it places upon who may enforce directors' duties. The rule is considered harshest where it operates to deny an individual shareholder

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15 The major common law duties on directors are: they must act bona fide in the best interests of the company; they must not exercise their powers for an improper (collateral) purpose; they are obliged to exercise the reasonable care and skill expected of persons of their knowledge and experience; and finally, they must not place themselves in a position where their duty to the company and their own interests conflict. See Farrar & Russell, above n 8, chapt 36.

16 Farrar & Russell, above n 8, p 224.

17 Gower ascribes this difference to the historical trustee analysis of directors' duties. The good faith requirements upon directors were virtually identical to those required of trustees, whereas the duty of a trustee was to be cautious and avoid risk of the trust property, in contrast to business managers who must, perforce, take risks. See Gower, above n 10, p 572.

18 *Percival* v *Wright* [1902] 2 Ch 421, where directors purchased shares from their shareholders without disclosing that they were in the process of negotiating a takeover bid at a higher price. It was held that since the directors owed no fiduciary duty to the shareholders they were not liable for non-disclosure.

19 See *Greenhalgh* v *Arderne Cinemas Ltd* [1951] 1 Ch 286, p 291.

20 See H A J Ford and R P Austin *Ford's Principles Of Corporations Law*, 6th ed, Butterworths, Sydney, 1992 ("Ford"), p 466, para 1435.

21 Ford, above n 20.

standing to sue in respect of a breach of a directors' duty, as the shareholder is not considered a beneficiary thereof. Indeed, the rule has been heavily censured for this limitation.[22]

2 *A duty to shareholders?*

There is, however, New Zealand case law to suggest that courts recognise that directors owe duties to their shareholders in certain circumstances.[23] *Coleman and Other* v *Myers*[24] is authority for this proposition.[25] In the High Court, Mahon J held that *Percival* v *Wright* had been decided "per incuriam",[26] and that directors could owe fiduciary duties to their shareholders in the context of a takeover.[27] On appeal, the Court of Appeal rejected Mahon J's reading down of *Percival* v *Wright.* Rather, the court was content to recognise the particular circumstances of the case gave rise to a fiduciary duty to shareholders, which the directors had breached. Thus, the fiduciary duty was not occasioned merely by the director-shareholder relationship. Cooke J, for example, was at pains to emphasise the special facts giving rise to the duty.[28] The upshot of *Coleman* v *Myers* is, therefore, not to limit *Percival* v

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22 See, Report of Cohen Committee (UK), Command Report 6659, paras 86-87 and Report of Jenkins Committee (UK), Command Report 1749, para 89, noted in Farrar & Russell, above n 8, p 225; and the comments of Mahon J in *Coleman* v *Myers*, see below n 24.

23 There is also other Commonwealth authority supporting the notion, for example, in *Gething* v *Kilmer* [1972] 1 All ER 1166, p 1170 where Brightman J took the view that where a takeover bid has been made, the directors of the offeree company were under a duty (which included a duty to be honest and not to mislead) to their own shareholders.

24 [1977] 2 NZLR 225 ("*Coleman* v *Myers*").

25 *Coleman* v *Myers* concerned a takeover of a family company at an undervalue by a new company formed by one of the directors of the family company.

26 "Per incuriam" roughly translates to "lack of care". A decision of a court is made per incuriam if it fails to apply a relevant statutory provision or ignores a binding precedent. In summarising counsels' submissions on the point, Mahon J had the following to say as to how legal commentators perceived *Percival* v *Wright*:

> *The Cohen and Jenkins Committees on Company Law in the United Kingdom each recommended the enactment of legislation in abrogation of the decision in* Percival v Wright. *Professor Gower has referred to the judgment as a "calamitous decision". P R Adams in* Company Directors in Australia *(2nd ed) 146-147 expresses a view that it must be doubted whether the case should now be followed. Professor Loss, one of the leading American experts on the American Securities Exchange legislation and himself a member for some time of the legal staff of the Securities and Exchange Commission, in an article, "The Fiduciary Concept as Applied to Trading by Corporate 'Insiders' in the United States" (1970) 33 MLR 34, 40-41, said that* Percival v Wright *was "a monument to the ability of lawyers to hypnotise themselves with their own creations".*

27 The particular duties expressed were not to mislead the shareholders and to disclose material matters to them. *Coleman* v *Myers,* above n 24, p 280:

> *I accordingly accede to the submission of Mr Wallace that on the facts of this case, where the director of a private company made an offer to shareholders to purchase shares he had a duty to disclose to such shareholders any material fact of which to his knowledge, they were unaware, and which reasonably might from an objective viewpoint, materially affect the decision of those shareholders as to whether they would sell or as to the terms of sale.*

28 See *Coleman* v *Myers*, above n 24, p 330. Such factors included the family character of the company, the position of the directors in the company and family, their high degree of inside knowledge, and the manner in which the takeover was conducted and shareholders persuaded.

Wright to its facts, so much as to demonstrate that additional factors, for instance inequality of bargaining power, may ameliorate the effect of the rule in the latter case.

3 *Impact of the 93 Act*

The foregoing overview of case law on directors' duties is largely mirrored in the statutory regime provided by the 93 Act. The 93 Act expressly recognises certain duties as being owed to shareholders.[29] Duties of directors relating to disclosure of interests and share dealings, and supervision of the share register, are said to be owed to shareholders.[30] By contrast, the duty of care[31] and the duties to avoid reckless trading and not to agree to a company incurring certain obligations comprised in sections 135 and 136 of the 93 Act, are owed to the company as an abstraction, and specifically not to shareholders.[32] The relationship of the 93 Act to the common law is explored subsequently.[33]

C *The Courts' Extension Of Directors' Duties To Include Creditors*

1 *Introduction: a derogation from the traditional conception?*

Purportedly one of the more interesting developments in the field of company law prior to the 93 Act was the extension of directors' duties to provide protection for companies' creditors.[34] For nearly two decades, in a growing number of decisions, the courts evidenced a sympathy

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29 93 Act, subsection 169(3) provides:

> **Certain duties owed to company but not shareholders** Without limiting subsection (1) of this section, the duties of directors set out in -
> (a) Section 90 of this Act (which relates to the duty to supervise the share register);
> (b) Section 140 of this Act (which relates to the duty to disclose interests);
> (c) Section 148 of this Act (which relates to the duty to disclose share dealings) -
> are duties owed to shareholders while the duties of directors set out in -
> (d) Section 131 of this Act (which relates to the duty of directors to act in good faith and in the best interests of the company);
> (e) Section 133 of this Act (which relates to the duty to exercise powers for a proper purpose);
> (f) Section 135 of this Act (which relates to reckless trading);
> (g) Section 136 of this Act (which relates to the duty not to agree to a company incurring certain obligations);
> (h) Section 137 of this Act (which relates to a director's duty of care); and
> (i) Section 145 of this Act (which relates to the use of company information) -
> are duties owed to the company and not to shareholders.

30 93 Act, paragraphs 169(3)(a), (b) & (c).

31 93 Act, section 137.

32 See above n 30..

33 See below Part III Section A - The Relationship Between The 93 Act And The Common Law As To Directors' Duties.

34 See R Grantham "The Judicial Extension of Directors' Duties to Creditors" [1991] JBL 1 ("Grantham"), p 1.

for the plight of creditors by prescribing recommendations as to director behaviour inclusive of considering the interests of creditors. In doing so they have seemingly been prepared at times to disregard the traditional conception that directors' duties are owed exclusively to the company, which, as noted, was usually equated with its shareholders.[35] This has therefore involved an extension of the orthodox conception of directors' duties.[36] The following section of the paper surveys the case law by jurisdiction before outlining the discernible parameters of the judicially formulated directors' duty in regard to creditors.

2 *Judicial observations regarding directors' obligations to creditors*

a *the Australian strand*

The first real attempt to establish that directors should give consideration to the impact of their actions upon creditors was the Australian High Court decision *Walker* v *Wimborne*.[37] Mason J's dictum appears to have become the starting point for all ensuing expositions of the concept:[38]

> ***The directors of a company in discharging their duty to the company must take account of the interests of*** *its shareholders and* ***its creditors****.* ***Any failure by the directors to take into account the interests of creditors will have adverse consequences*** *for the company as well as* ***for them****. The creditor of a company ... must look to that company for payment. His interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent.*[39]

An important issue throughout the cases is when the duty will arise. The debate concerns whether insolvency is significant or not. Mason J's statement contains nothing to suggest

35 See above, Part II Section B - Traditional Conceptions Of To Whom Directors Owe Duties.

36 Prior to 1975 and the *Walker* v *Wimborne* decision, see below n 37, the cases uniformly reject the idea that creditors' interests may be taken into account. See *Re Wincham Shipbuilding Boiler & Salt Co.* (1878) 9 Ch D 322; *Re Drawfield Silkstone Coal Co.* (1881) 17 Ch D 76; and *Salomon* v *Salomon* [1897] AC 22, cited in D A Wishart "Models and Theories of Directors' Duties for Creditors" (1991) 14 NZULR 323 ("Wishart"), p 325.

37 (1976) 50 ALJR 446; (1975) 137 CLR 1. Noted by R Barrett (1977) 40 MLR 226 ("Walker v Wimborne").

38 Above n 37, p 449; 5 (emphasis added).

39 *Walker* v *Wimborne,* above n 37, involved a liquidator's misfeasance summons under section 367B of the New South Wales Companies Act 1961. The summons was in respect of, first, a pension to a retired director, secondly, an intergroup loan between two insolvent companies, thirdly, salaries paid by an insolvent company, and fourthly, an intergroup payment by an insolvent company for work that was never done. On appeal the Australian High Court held the lower court had rightly rejected the first cause of action, but wrongly the second, third and fourth. For an exposition of the fact pattern of *Walker* v *Wimborne* see below Part IV Section C Subsection 1 - *Walker* v *Wimborne*.

insolvency triggers the duty to take account of creditors' interests.[40] Indeed, Mason J appears to have envisaged future prejudice in the event that the company became insolvent.

Another Australian case, *Ring* v *Sutton,*[41] is support for the suggestion that the duty to consider creditors' interests extends beyond the insolvency of the company. In the case, the New South Wales Court of Appeal examined a transaction which was entered into when the company was solvent.[42] The court noted the transaction at issue did not benefit the company, was in fact detrimental to it, and was designed in order to benefit a director of the company.[43]

A further issue with regard to the parameters of the duty is ratification of a possible breach by shareholders. In this regard, Hope J A noted, in response to an argument that shareholders had consented to the transaction at issue and therefore the liquidator could not complain:[44]

> *The present case is one that concerns the interests of creditors and it has not been nor could it be suggested that they approved or affirmed the terms of the loan contracts.*

In so rejecting the possibility of shareholder ratification, Hope J arguably perceived the duty breached as being owed to the company's creditors and thus the conduct of the company's shareholders was irrelevant.

In 1986, the New South Wales Court of Appeal again had an opportunity to consider creditors' interest. *Kinsela and Anor* v *Russell Kinsela Pty Ltd (in liq)*,[45] in contrast to *Ring* v *Sutton* for example, saw the court emphasise an insolvency/solvency dichotomy[46] as to when

40 The company was, however, insolvent at the time of the impugned transactions. See J Dabner "Directors' Duties - The Schizoid Company" (1988) Co & Sec LJ 105 ("Dabner"), p 106.

41 (1980) 5 ACLR 546.

42 In *Ring* v *Sutton* a loan at less than market rates was entered into whilst the company was solvent but was held to be detrimental to the creditors' interests. It was successfully challenged in a misfeasance summons by a liquidator in a creditors' voluntary winding up. For an exposition of the fact pattern of *Ring* v *Sutton* see below Part IV Section C Subsection 2 - *Ring* v *Sutton*.

43 See above n 41 where the court noted:

> *None of the three transactions was for the benefit of the company, their terms as to interest were detrimental to the company and were arrived at for the benefit of the respondent and the respondent was able to procure the terms because of his position as a director.*

44 *Ring* v *Sutton*, above n 41, p 548.

45 (1986) 4 ACLC 215 ("*Kinsela*").

46 See below n 47 and accompanying text.

the interests of creditors should be considered.[47] On the facts, the company was clearly insolvent at the time of the challenged transaction, so it was unnecessary for the court to formulate a general test as to the degree of financial instability required to impose upon directors an obligation to consider the interests of creditors. Again, in the context of shareholder ratification of directors' actions, Street C J stated directors' duties incorporate not prejudicing the interests of creditors:[48]

> *It is, to my mind, legally and logically acceptable to recognise that, where directors are involved in a breach of their duty to the company affecting the interests of shareholders, then shareholders can either authorise that breach in prospect or ratify it in retrospect. Where, however, the interests at risk are those of creditors I see no reason in law or logic to recognise that the shareholders can authorise the breach.* ***Once it is accepted, as in my view it must be, that the directors' duty to a company as a whole extends in an insolvency context to not prejudicing the interests of creditors*** *(*Nicholson & Ors *v* Permakraft (N.Z.) Ltd *and* Walker *v* Wimborne*) the shareholders do not have the power or authority to absolve directors from that breach.*

Street C J's dictum also gives an indication as to the rationale behind the duty to creditors, noting that insolvency substantively meant the assets of the company under the management of the directors are the creditors and not the shareholders: hence the duty.[49]

In another 1986 decision, *Grove* v *Flavel,*[50] the Supreme Court of South Australia was, in contrast to *Kinsela*, required to delineate the degree of insolvency required to give rise to the duty.[51] The issue before the court was whether the director in question had made improper

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47 *Kinsela,* above n 45, concerned the validity of a lease granted by the company whilst in a state of imminent collapse to two of its directors. On the facts the aim of the transaction was to put the assets beyond the reach of creditors. The lease had been approved by all the shareholders. For an exposition of the fact pattern of *Kinsela* see below Part IV Section C Subsection 3 - The *Kinsela* case.

48 *Kinsela,* above n 45, p 223.

49 *Kinsela,* above n 45, p 221, where Street C J commented while:

> *In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company ... where a company is insolvent the interests of the creditors intrude ... It is in a practical sense their assets and not the shareholders' assets that ... are under the management of the directors ...*

50 (1986) 4 ACLC 654.

51 The facts of *Grove* v *Flavel,* above n 50, was that a director of seven companies had been charged with seven breaches of the duty not to make improper use of information, namely, that a particular company was experiencing liquidity problems. The director, in possession of such knowledge, had effected a round robin movement of cheques amongst the company facing insolvency, himself, and other of the debtor and creditor companies he controlled. The result was that the debt to the director was reduced, and the director and companies which had previously been debtors of the troubled company became debtors of another company, which had previously been a creditor of the troubled company, thus effectively extracting the troubled company from the

use of information. Jacobs J, after referring to *Kinsela* and New Zealand's *Permakraft* case[52] and noting that the insolvency/solvency distinction was not rigidly applied (especially by Cooke J in the latter case) concluded that the duty to creditors not only arises when the company is insolvent but also where the director has "knowledge of a real risk of insolvency".[53] Whether there is such a real and perceived risk of insolvency apparently depends upon the facts of each case. With regard to the type of conduct that would breach the duty, Jacobs J noted:

> *A director of a company X Limited who upon acquiring information which leads him to believe that the company faces a risk of liquidation ... which is real and not a remote risk and thereupon acts to protect himself and other companies which he is a director from the consequences of such liquidation to the possible detriment of creditors of X Limited is acting improperly.*

It has been suggested *Grove* v *Flavel* is authority that liquidators have a cause of action for breach of duty against a director who entered into a transaction at a time when the director perceived the company was in financial difficulties and a creditor of the company suffers a loss as the result of the transaction.[54]

The final case of the Australian strand of common law supporting a directors' duty to creditors is *Jeffree* v *National Companies and Securities Commission.*[55] In *Jeffree* the Full Supreme Court of Western Australia was unanimous that the failure of directors to ensure that creditors were adequately covered in the context of a rearrangement of the financial affairs of the company was fatal to the director.[56] The company director, Jeffree, was sued by the

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arrangement. For an exposition of the fact pattern of *Grove* v *Flavel* see below Part IV Section C Subsection 4 - *Grove* v *Flavel*.

52 See below n 59. See below Part II Section C Subsection 2 Paragraph b - New Zealand authority & Part IV Section b Subsection 1 - *Permakraft*.

53 *Grove* v *Flavel,* above n 51, p 663.

54 Dabner, above n 40, p 109.

55 (1989) 15 ACLR 217; 7 ACLC 556 ("*Jeffree*").

56 The facts of *Jeffree*, above n 55, are these: Mr Jeffree was a director of a company known as Wanup Limited. Wanup Limited was the trustee of Mr Jeffree's family trust. It carried on a swimming pool business for the beneficiaries of the trust. A dispute had arisen between Wanup Limited and another company Leighton Limited. That dispute was sent to arbitration. Jeffree feared that an award would be made against Wanup Limited and that it would not have sufficient assets to satisfy the award. He sought legal advice which he understood authorised him to incorporate a new corporate trustee, Cassidy Limited, the establishment of a new family trust with the same director/shareholders and beneficiaries as were involved in the Wanup Limited family trust, and the transfer of the assets and business of Wanup Limited to Cassidy Limited for full value. This was accomplished on the facts. As anticipated, following the transfer of the assets to Cassidy Limited, the arbitrator made a substantial award against Wanup Limited (now a shell). Jeffree was convicted under section 229(4) of the Companies Code (Aust), see below n 57 by the Stipendiary Magistrate, and an appeal dismissed, the Court was satisfied that Jeffree had

liquidator for a breach of section 229(4) of the Companies Code(Aust)[57] and convicted. Martin S M, at first instance, after noting that a director who acts in the best interests of the company is free from any possible criticism, held that where financial difficulties confront a company the duties of directors become quite different. At that stage, directors have to take into account the concerns of creditors and failure to do so results in a breach of duty. The Full Court agreed with this approach. Significantly, Brinsden J emphasised that the duty was owed to both present and future creditors.[58]

b New Zealand authority

The matter of directors' duties to creditors was considered in some depth by New Zealand's Court of Appeal in the 1985 landmark decision *Nicholson* v *Permakraft (N.Z.) Ltd (in liq)*.[59] The case, like almost all in this area, involved proceedings by a liquidator.[60] The High Court held the directors, in failing to take account of the interests of the company or its creditors, were guilty of a breach of duty. An appeal was allowed by the Court of Appeal against the finding that the directors had not considered the interests of the company because the finding ran contrary to the evidence. The company was solvent and there existed sound commercial reasons for the restructuring. The court concluded the decisions of the directors could, therefore, be regarded as reasonable at the time and not unfair to creditors.

Cooke J did, however, entertain some important dicta concerning the question of a duty to creditors:[61]

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obtained an advantage for himself and Wanup Limited by ensuring that all the assets of Wanup were removed before the creditor Leighton Limited could get at those assets. The fact that the assets had been transferred at full value was irrelevant for determining whether there had been a breach of the section.

57 Companies Code (Aust), section 229(4) provides:

> An officer or employee of a [company] shall not make improper use of his position as such an officer...to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the [company].

58 *Jeffree,* above n 55 p 228; p 566, where Brinsden J noted:

> *The advantage he [Jeffree] got however, was, that he was able to continue to work for the same business under a fresh corporate structure unimpeded by claims of a prospective creditor...*

59 [1985] 1 NZLR 242 ("*Permakraft*").

60 In *Permakraft,* above n 59, the company had been restructured in 1975 by the incorporation of a new company, Holdings, the distribution of a capital profit upon revaluation of properties, the purchase by the company's shareholders of shares in Holdings and a simultaneous sale of most of their shares in the company to Holdings. The effect of this scheme was to reduce the pool of assets available to creditors. Two years later the company was ordered to be wound up and the liquidator commenced proceedings to recover the amount of the capital dividend. For an exposition of the fact pattern of *Permakraft* see below Part IV Section B Subsection 1 -*Permakraft.*

61 *Permakraft,* above n 59, p 249 (emphasis added).

> *The duties of directors are owed to the company.* ***On the facts of particular cases this may require the directors to consider inter alia the interests of creditors. For instance creditors are entitled to consideration, in my opinion, if the company is insolvent or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency.***
>
> *The criterion should not be simply whether the step will leave a state of ultimate solvency according to the balance sheet, in that total assets will exceed total liabilities ... Balance sheet solvency and the ability to pay a capital dividend are certainly important factors tending to justify proposed action. But* ***as a matter of business ethics it is appropriate for directors to consider also whether what they do will prejudice their company's practical ability to discharge promptly debts owed to current and likely continuing trade creditors****.*
>
> *To translate this into a legal obligation accords with the now pervasive concepts of duty to a neighbour and the linking of power with obligation ... In a situation of marginal commercial solvency such creditors may fairly be seen as beneficially interested in the company or contingently so ...*
>
> *The recognition of duties to creditors ... is justified by the concept that limited liability is a privilege. It is a privilege healthy as tending to the expansion of opportunities and commerce; but it is open to abuse. Irresponsible structural engineering - involving the creating, dissolving or transforming of incorporated companies to the prejudice of creditors - is a mischief to which the Courts should be alive. But a balance has to be struck. There is no good reason for cultivating a paternal concern to protect business people perfectly able to look after themselves ...*

Further to these comments about the directors' duty to the company, Cooke J also added there existed a possibility of an action by creditors against the directors or the company for a breach based in negligence.[62] Although concern has been noted that these comments suggest Cooke J was contemplating a duty of care owed directly to creditors,[63] it is apparent from his comments that any such duty would be fact specific. In summary, Cooke J appears to have propounded an objective test based on whether directors ought to have known the particular activity was likely to cause loss to creditors.[64] Further, where such a duty is owed, the unanimous consent of shareholders will not be sufficient to justify the breach of duty, merely compounding rather than excusing the breach as against the creditors.

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62 *Permakraft,* above n 59, p 250, where Cooke J stated the duty to the company:

> *... does not exclude the possibility of an action by a particular creditor against the directors or the company for breach of a particular duty of care arising on ordinary negligence principles.*

63 See Grantham, above n 34, p 7.

64 As such, Cooke J adopted the approach of Cumming-Bruce and Templeman LJJ in *Re Horsley & Weight Ltd* [1982] Ch 442, pp 454-456, where both Lord Justices favoured an objective approach. *Permakraft,* above n 59, p 250, per Cooke J.

Cooke J's obiter dicta was endorsed in the High Court a year later by Smellie J in *Neil & Co Ltd (in rec)* v *Neil.*[65] Smellie J reproduced the passage of Cooke J quoted above,[66] and while noting the passage was particularly apposite to the case before him, it was obiter dicta. Nevertheless, Smellie J felt the principles enunciated in the passage could be regarded as legitimate (when taking them into account for the purpose of exercising his discretion to remove a caveat under section 143 of the Land Transfer Act 1952).[67]

Finally, in *Hilton International Limited (in liq)* v *Hilton*[68] Tipping J considered the authorities on directors' duties in the context of the distribution of a capital dividend.[69] He held the directors of a company, when declaring a dividend, owe a duty not only to the company but also to its creditors, of all kinds likely to be affected, to act in accordance with the legal principles relating to the making of distribution.[70] In so doing, Tipping J, as Smellie J had done in *Neil*, endorsed Cooke J's dicta in *Permakraft*:[71]

> *I respectfully agree with the approach suggested by Cooke J in the* Nicholson v Permakraft *case. As His Honour emphasised limited liability is a privilege which must be matched by certain responsibilities. There is no doubt about the duties of directors to act honestly and I do not consider that it is placing too burdensome a responsibility on them when declaring a dividend to consider the financial position of the company carefully so as to ensure that the dividend is not paid unless they honestly and reasonably believe that the company's financial health and its creditors will not thereby be jeopardised.*

65 (1986) 3 NZCLC 99,659 ("*Neil*"). The matter arose in the context of a caveat lodged by the governing and sole director of an insolvent company against its only assets which he had agreed to buy the day prior to the bank appointing the receivers. The receivers purported to cancel the contract. Smellie J held the contract was void and possibly void ab initio. For an exposition of the fact pattern of *Neil* see below Part IV Section B Subsection 3 - *Neil*.

66 See text accompanying above n 65.

67 See *Neil,* above n 65, where Smellie J noted:

> *... the principles enunciated by Cooke J were distilled by him after full and detailed argument in which the law in England, Australia and New Zealand was traversed. When those principles are placed alongside the facts in this case I consider it legitimate to take the combined effect into account in exercising any discretion.*

68 (1988) 4 NZCLC 64,721 ("*Hilton*").

69 The dividend had been declared and paid when the company was experiencing liquidity problems. Although the facts of the case are complex, the issue was relatively simple; the liquidators arguing the capital dividend had been declared contrary to the law and either fraudulently or negligently. No fraud was found but it was held an unlawful return of capital took place which constituted a breach of duty. For an exposition of the fact pattern of *Hilton* see below Part IV Section B Subsection 2 - The *Hilton* case.

70 *Hilton*, above n 68, p 64,751.

71 *Hilton*, above n 68, p 64,750.

Tipping J also cautioned that ratification of directors' actions by the company's shareholders would not protect directors from a breach of such duty.[72]

c *conflicting English dicta*

The first English case to consider the issue of creditors' interests was *Lonrho Ltd v Shell Petroleum Co Ltd*[73] in 1980. Diplock LJ in the House of Lords noted "the best interests of the company are not necessarily those of shareholders but may include those of the creditors".[74] However, subsequent decisions appeared comprehensively to reject the existence of a duty to creditors. The English Court of Appeal in *Re Horsley & Weight Ltd*[75] in 1982 heard an argument by a liquidator that a payment of a pension to a director was in breach of a duty owed to the company's creditors to preserve its capital fund. Buckley LJ noted although it may be somewhat loosely said that the directors owe an indirect duty to creditors not to permit any unlawful reduction of capital to occur, it was in fact more accurate to say that the directors owe a duty to the company in this respect and if the company went into winding up, the liquidators owe a duty to enforce the right to repayment.[76] Notwithstanding this apparent rebuke, other members of the court have often been cited as authority for recognising the existence of a duty to creditors.[77] For example, Templeman LJ stated:[78]

> *If the company had been doubtfully solvent at the date of the grant to the knowledge of the directors the grant would have been both a misfeasance and a fraud on the creditors for which the directors would be liable.*

Although it is arguable that the passage is acknowledgment by Templeman LJ of misfeasance in the form of a breach of a duty to creditors, it is also equally arguable that the passage refers to a misfeasance vis-a-vis the company and a fraud on the creditors. Directors have invariably been liable for fraud on creditors. Cumming-Bruce LJ concurred with Templeman

72 *Hilton*, above n 68, p 64,751.
73 [1980] 1 WLR 627 ("*Lonrho*").
74 *Lonrho*, above n 73, p 634. It should be noted His Lordship did not refer to any authority for the proposition and the passage arose by way of side remark incidental to the issues of the case.
75 [1982] 3 All ER 1045 ("*Horsley*").
76 *Horsley*, above n 75, p 1055.
77 Dabner, above n 40, p 108.
78 *Horsley*, above n 75, p 1058.

LJ and together it has been said that these two judgments are "the strongest English authority for the proposition that a duty is owed to creditors".[79]

In *Multinational Gas and Petroleum Co v Multinational Gas and Petroleum Services Ltd* [80] the English Court of Appeal discounted the possibility of a duty to creditors. Unsurprisingly the case concerned an action by a liquidator.[81] By a majority, it was held that where shareholders had approved the directors' acts, these became acts of the company and barred a claim by the liquidator against the company. Dillon LJ commented:[82]

> ***An individual trader who is solvent is free to make stupid but honest commercial decisions in the conduct of his own business. He owes no duty of care to future creditors ... A company ... likewise owes no duty of care to creditors****. The directors indeed stand in a fiduciary relationship to the company as they are appointed to manage the affairs of the company and they owe fiduciary duties to the company though not to the creditors, present or future ...*

In contrast, possibly the strongest authority in support of a duty to creditors derives from the judgment of Templeman LJ in the House of Lords' decision *Winkworth* v *Edward Baron Development Co Ltd & Ors*[83] where he affirmed his view in *Horsley* that a duty is owed to creditors.[84] He stated, and the other law lords agreed:[85]

> *...* ***a company owes a duty to its creditors, present and future****. The company is not bound to pay off every debt as soon as it is incurred and the company is not obliged to avoid all ventures which involve an element of risk, but* ***the company owes a duty to its creditors to keep its property inviolate and available for repayment of its debts****. The conscience of the company, as well as its management, is*

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79 See Dabner, above n 40, p 108.

80 [1983] 3 WLR 492; [1983] 2 All ER 563 ("*Multinational*").

81 *Multinational*, above n 80, had complex facts that, however, the case basically gave rise to the issue of whether the shareholders of the company could ratify the conduct of directors who had entered the company into improvident contracts. The liquidator alleged that the directors were in breach of duty by virtue of entering into high risk contracts notwithstanding that the company was solvent at that time.

82 *Multinational*, above n 80, p 514;585 (emphasis added).

83 [1987] 1 All ER 114 ("*Winkworth*").

84 At issue in *Winkworth*, above n 80, was a claim by a wife in respect of an equitable interest in the proceeds of the sale of a matrimonial house. The proceeds had been paid into the overdrawn bank account of a family company of which the wife and husband were both shareholders and directors. The pair had used the company's funds for the purchase of shares in question and had caused the company to purchase a house which had served as the matrimonial house. Unknown to the wife the husband had mortgaged the house to Winkworth, forging his wife's signature in the process. The immediate issue was whether the wife had an equitable interest which prevailed over the mortgagee's. The House of Lords allowed the appeal by the mortgagee. For an exposition of the fact pattern of *Winkworth* see below Part IV Section D Subsection 1 - The *Winkworth* decision.

85 *Winkworth*, above n 83, p 118 (emphasis added).

> *confined to its directors. A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of directors themselves to the prejudice of the creditors.*

Finally, a further decision of the English Court of Appeal has added to the obiter dicta that directors may owe duties towards their company's creditors, or perhaps more cautiously, that directors' duties, although owed to the company, include an obligation to have regard to the interests of creditors. The decision, *Liquidator of West Mercia Safetywear Ltd* v *Dodd*,[86] restricted the approach of the *Multinational* case to solvent companies and accepted that in the case of insolvent companies directors are under a duty to take creditors' interests into account when disposing of company property.[87]

The case dealt with a liquidator's application for a declaration that the company's director, Dodd, was guilty of misfeasance and breach of trust in relation to the company. Although dismissed at first instance on the authority of *Multinational*, the Court of Appeal upheld the appeal. Dillon LJ[88] held there was a clear fraudulent preference and thus misfeasance on the part of the director who owed a fiduciary duty to the company defrauded. The transfer constituted a fraudulent preference in disregard of the interests of the general creditors of the insolvent company. Dillon LJ, after approving Street CJ's dicta in *Kinsela,*[89] distinguished *Multinational* on the basis of solvency:[90]

> *In the Multinational case, at the time of the transaction which was in question, the company was amply solvent, and what the directors had done at the bidding of the shareholders had merely been to make a business decision on good faith, and act on that decision. It subsequently turned out to be a bad*

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86 (1988) 4 BCC 30 ("*West Mercia*"). Noted by A Herzberg (1989) Co & Sec LJ 72.

87 *West Mercia*, above n 86, concerned two related companies, A J Dodd & Co Ltd and its wholly owned subsidiary West Mercia Safetywear Ltd. Both companies had accounts with Lloyds Bank, West Mercia's being in credit whilst Dodd's was overdrawn. As security for the overdraft facility the Bank had a charge on the book debts of Dodd Limited, as well as a personal guarantee from Mr Dodd, who was a director of both companies. The book debts of Dodd Ltd included a debt of approximately £30,000 from West Mercia Ltd. Both companies were discovered to be insolvent. The directors were advised to place the companies in voluntary winding up and not to operate West Mercia Ltd's bank account until all procedural meetings had been called. Later both companies were placed in creditors' voluntary winding up. However, two weeks prior, Mr Dodd had, contrary to advice, instructed £4,000 to be transferred from West Mercia Ltd's account to Dodd Ltd's, the intention being to reduce Dodd Ltd's overdraft which Mr Dodd had guaranteed. For an exposition of the fact pattern of *West Mercia* see below Part IV Section D Subsection 2 - The *West Mercia* case.

88 With whom Croom-Johnson LJ and Caulfield J agreed.

89 See text accompanying above n 48.

90 *West Mercia*, above n 86, p 33.

decision, but the position had to be decided on the facts at an earlier stage where the company was amply solvent and the parties were acting in good faith.

D The Parameters Of The Common Law Duty To Consider Creditors

Thus, it is evident the courts in the anglo-antipodean jurisdictions have demonstrated considerable sympathy with the plight of creditors of (predominantly) insolvent companies. From the foregoing it is possible to discern the basic elements of what has generally been conceded to be a common law duty to creditors.[91] The parameters of the duty are, nevertheless, not clear cut and may equally be described as issues.

1 To whom is the duty owed? to the company or to creditors

As noted earlier, it has been a tenacious principle of commonwealth company law that directors' duties are owed to the company alone[92] and not to third parties dealing with the company, such as creditors. The dicta contained in the foregoing section is clearly supportive of some duty running from directors to creditors. The importance of terminology cannot be understated, however. There is a clear distinction to be drawn between saying that a director owes a fiduciary duty to a creditor and stating that a director has a duty to consider the interests of creditors. The former not only imposes a duty upon directors but also, and significantly, implies that creditors can enforce the duty themselves. The latter rationalisation would oblige directors to consider the interests of creditors, but the duty would ultimately be owed to the company, and accordingly, it would be enforceable by the company alone.[93]

The cases, where they do so, appear on the whole to articulate an orthodox conception of a directors' duty to creditors. Mason J in *Walker v Wimborne*[94] and Cooke J in *Permakraft* [95]

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91 See Farrar, above n 8; L S Sealy "Directors 'Wider' Responsibilities - Problems Conceptual, Practical and Procedural" (1987) 13 Monash ULR 165 ("Sealy-Monash"); F Dawson "Acting in the Best Interests of the Company - For Whom Are Directors Trustees?" (1984) 11 NZULR 68 ("Dawson"); Dabner, above n 40; P D Giugni and J L Ryan "Company Directors' Spheres Of Responsibilty: Primary And Secondary Duties" [1988] NZLJ 437.

92 See *Percival* v *Wright*, discussed above n 26, and generally - Part II Section B Subsection 1 - The orthodox view: exclusively to the company.

93 This is the essence of the rule in *Foss* v *Harbottle* (1843) 2 Hare 461.

94 See *Walker* v *Wimborne*, above n 37, p 7, where Mason J declared (emphasis added):

> *... in this respect it should be emphasised that the directors of a company is discharging **their duty to the company** must take account of the interests of its shareholders and its creditors.*

endorsed such a formulation. The comments of Templeman LJ in *Winkworth* are inconsistent with this approach, however. His Lordship seemed to indicate in clear terms that the duty to consider the interests of creditors was owed not just to the company, but to the creditors themselves.[96] Commentators have been critical of such an interpretation[97] (notwithstanding the ambiguity of its expression), whilst Wishart, for example, is of the view the issue is as yet undecided.[98]

2 *When will the duty arise? is insolvency necessary?*

This has been identified by many commentators as a crucial area of uncertainty.[99] A number of the cases suggest the duty only arises, if at all, where the company is insolvent. For example, in *West Mercia*, Dillon LJ based his retreat from his dictum in *Multinational* on the ample solvency of the company in *Multinational*. Similarly, Street CJ's comments in *Kinsela* referred to creditors' interests only intruding in the case of an insolvent company. Furthermore, in *Permakraft*, Richardson J observed: "If a company is solvent in the sense of its assets exceeding its liabilities there can, I think, be no question of a separate duty to creditors."[100] The absence of consensus as to the meaning of "insolvency" adds to the uncertainty. Richardson J referred to a balance sheet conception of solvency[101] in the

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95 See *Permakraft*, above n 59 , p 245, where Cooke J surmised (emphasis added):

> *The duties of directors are* ***owed to the company****. On the facts of particular cases this may require the directors to consider inter alia the interests of creditors.*

This analysis is supported by Cooke J's later comments concerning the possibility if action being brought against a director directly by a creditor for a breach of a duty of care on ordinary negligence principles. See *Permakraft*, above n 59, p 250.

96 See *Winkworth*, above n 83, p 117, where Templeman LJ said (emphasis added):

> *A duty is owed by the directors to the company* ***and to the creditors of the company*** *to ensure that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of those creditors.*

97 See C A Riley "Directors' Duties and the Interests of Creditors" 10 Co Lawyer 87, p 91 and Dawson, above n 91, p 77 for example.

98 Wishart, above n 36, pp 326 & 327, where he notes (footnotes omitted and emphasis added):

> *Dicta of Cooke J in* Nicholson *v* Permakraft, *Lord Templeman in* Winkworth *v* Edward Baron Development Co *and Wallace J in* Jeffree *v* National Companies and Securities Commission *seem to support some sort of direct duty, but* ***no case can be said to have decided the point****..*

99 For example, Wishart has identified the following unanswered questions:

> *(i) Does the duty continue for the whole of the life of the company?*
>
> *(ii) If so, does the duty require greater or even prime consideration of creditors' interests as insolvency approaches?*
>
> *(iii) If the duty is not a continuing one, what event brings it into existence? Is it insolvency, and if so, what form of insolvency? If not, what triggers the degree of financial insecurity which should trigger the duty? Most cases refer at some stage to "doubtful solvency".*

See Wishart above n 36, p 329 (footnotes omitted).

100 *Permakraft*, above n 59, p 254

101 Balance sheet solvency is an excess of assets over liabilities.

foregoing dictum, as did Somers J in *Permakraft*,[102] whilst Cooke J took a broader view noting both balance sheet solvency and liquidity solvency[103] were relevant.[104]

By contrast, it is arguable that the common law duty does not depend upon the company's insolvency (however defined). In *Walker* v *Wimborne*, Mason J appeared to accept that there was a continuing obligation irrespective of the financial health of the company, noting creditors could only ever look to the company for payment and thus would always be threatened by the possibility of future insolvency. In support of such an interpretation are Diplock LJ's comments in *Lonrho*, where in suggesting that the company's interests might include those of its creditors, no special circumstances such as insolvency appear necessary as a prerequisite to the existence of the duty.[105] In practice, however, it is submitted the imposition of a continuing duty to creditors whilst the company is solvent will be of little moment because the issue only gains any real significance upon pending or actual insolvency.[106]

3 *The extent and content of the duty*

This is perhaps the most fundamental aspect of the duty and yet there appears a conspicuous lack of any meaningful attempt to articulate an adequate definition of exactly what directors are required to do. Are the interests of the creditors merely one competing interest to be borne in mind by directors in their running of the company? and if so, how much prominence are they to be given? This "competing interest" approach appears implicit in Mason J's comments in *Walker* v *Wimborne*, where he spoke of the need to take account of the interests of both the creditors and shareholders.[107] Likewise, in *Permakraft*, Cooke J observed "on the facts of the particular case, this may require the directors to consider *inter alia* the interests of creditors".[108] The practicality of such an approach, however, is to be questioned. To talk in

102 *Permakraft*, above n 59, p 255.

103 Liquidity solvency has been defined as the capacity to discharge its debts as they become due in the normal course of business.

104 *Permakraft*, above n 59, p 249.

105 See *Lonrho*, above n 75, p 634.

106 Wishart's comment: "It is obviously superfluous to require directors to take account of the interests of creditors when the company's debts will be paid as and when they fall due" is particularly apt. Wishart, above n 36, p 329.

107 See above Part II section 7, subsection 2, paragraph (a) - The Australian Strand, in text accompanying above n [33].

108 *Permakraft*, above n 59, p 249 (italics added).

terms of competing interests seems to suggest that the duty owed prescribes consideration of varying claims, rather than the pursuit and championing of a particular group's interest. Such an approach has been the subject of criticism at a conceptual level.[109] It has been suggested that a duty expressed in terms of merely considering interests is, in effect, worthless, for the supposed beneficiary of the duty would never be able to show that their interests were not at least considered. At first blush, these sentiments appear pertinent to the concept of a common law duty to the company to consider creditors' interests.[110]

Two objections to these criticisms might be raised. First, one could query the extent to which *any* fiduciary duty imposed upon directors, including those to shareholders, is strictly enforceable. It can be argued that the separation of ownership and control, the reduced effectiveness of the general meeting as a means for controlling directors and the practical problems and limitations of the derivative action undermine the suggestion that even a duty expressed only in terms of considering shareholder's interests is itself not readily enforceable in practice.[111]If this is accepted, , the discretion granted to directors by the inclusion of creditors' interests within the interests of the company is recognised as being of importance, rather than the effectiveness of the enforcement mechanism. Although it is conceded there is some merit in this argument, it ought not to be overstated. If discretion to act, rather than compulsion to act, characterises the common law duty, then it pre-supposes that directors will wish to pursue this objective of their own volition. Directors have always been able to consider the interests of other groups, apart from shareholders, if to do so was in the long term interest to the shareholders.[112] Arguably, directors of their own volition have always had the discretion to consider creditors' interests. It may then be asked: what is added by a common law duty whose effectiveness lies not in its ability to compel compliance but merely in the discretion it grants to directors who wish to comply and have the discretion to do so already?

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109 Sealy-Monash, p 175 where the author notes:

> *But where duties are owed to persons with potentially opposed interests, the duty bifuricates and fragments so that it amounts ultimately to no more than a vague obligation to be fair; and (however much we may decide ourselves) this kind of "fairness", especially ina commercial context, is not a justiciable issue.*

110 Sealy-Monash, above n 91, pp 174 - 188.

111 See M Stokes "Company Law and Legal Theory" in W Twining (ed) *Legal Theory and Common Law* cited in C A Riley "Directors' Duties and The Interests of Creditors" 10 Comp Lawyer 87, p 89.

112 An example is the case of employees, where higher paid employees could be justified even though it may reduce profits and thus dividends, because in the long term it would foster better staff relations, attract and retain better workers and therefore increase long term profitability.

A further response to the worthless duty criticism is perhaps more compelling. Demanding consideration of creditors is not tantamount to saying that a director can pay lip service to this procedural requirement. The duty should compel something more than a mere statement after the event that the directors gave a thought to the creditors (but then decided to act in a way contrary to their interests). Given the possibility of a liquidator or a creditor bringing a misfeasance proceeding[113] it is conceivable such a proceeding could act as a sufficient inducement for directors to follow the prescribed activity of considering creditors' interests. Thus, to this extent, the duty may possibly yet have real application.

A final conceptual problem with a duty to consider several groups' interests is the ability of directors to comply in practice. Particularly where a company is insolvent, the interests of creditors and shareholders, for example, directly conflict. How is a director to discharge his or her duty to consider both these interests? The conflict, is perhaps best illustrated by the differing propensities of creditors and shareholders towards risk. How are directors to balance such competing interests when deciding whether to embark upon a speculative venture? Indeed, the courts have not been adverse to attempting to have it both ways. Templeman LJ's dictum in *Winkworth* is perhaps the best example, where he observed:[114]

> *The company is not bound to pay off every debt as soon as it is incurred, and a company is not obliged to avoid all ventures which involve an element of risk, but it owes a duty to its creditors to keep its property inviolable and available for the repayment of its debts.*

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113 Pursuant to the 93 Act, section 301. Subsection 301(1) provides:

301(1) Court's Power If, in the course of the liquidation of a company, it appears to the Court that a person who has taken part in the formation or promotion of the company, or a past or present director, manager, liquidator, or receiver of the company, has misapplied, or retained, or become liable or accountable for,money or property of the company, or been guilty of negligence, default, or breach of duty or trust in relation to the company, the Court may, on the application of the liquidator or a creditor or shareholder,-

(a) Inquire into the conduct of the promoter, director, manager, liquidator, or receiver; and

(b) Order that person-

(i) To repay or restore the money or property or any part of it with interest at a rate the Court thinks just; or

(ii) To contribute such sum to the assets of the company by way of compensation as the Court thinks just; or

(c) Where the application is made by a creditor, order that person to pay or transfer the money or property or any part of it with interest at a rate the Court thinks just to the creditor.

114 *Winkworth*, above n 83, p 118.

It is, however, suggested that, provided the prescribed procedure has been followed by directors and there is evidence that each respective groups' interest was considered, the weight to be accorded to those interests in the final decision arrived at must be for the directors to determine alone. Moreover, , at least with the onset of insolvency, it is arguable that the interests of the company become the interests of the creditors alone, and that accordingly only that interest must be borne in mind and pursued by the directors.[115] Such a formulation would appear to largely mitigate the problems and weaknesses of the conflicting interests dilemma. Nonetheless, practical difficulties still remain. To talk of creditors' interests is to overlook that creditors are not a homogenous group. The unsecured creditor is clearly in a quite different position from the company's bankers who may hold a floating or fixed charge over the company's property as security for its overdraft. Similarly, secured and unsecured creditors. Would a decision to foreclose a company at a time when there are sufficient assets to pay off the secured creditors but no one else be in the creditors' best interests? Or, vice versa, if in a similar situation, the directors decided to continue trading in the hope of generating further assets to enable payment of the other creditors, they would be risking the company's ability to pay its secured creditors. Would this be an attempt to discharge the duty or an obvious breach of it? Cooke J in *Permakraft* distinguished between future and existing creditors, when he noted that future creditors, in deciding to do business with the company, could be guardians of their own interests, a choice which he felt was clearly denied to existing creditors..

4 *Can there be exculpation?*

It may be asked, if the duty to regard the interests of creditors is owed to the company, or perhaps even if it is owed to the creditors, is exculpation[116] of the directors by shareholders of the company possible or effectual?[117] The issue is not without significance. Much of the case law purporting to evidence a common law duty to creditors involves fact patterns where

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[115] See the comments of Street CJ in *Kinsela*, above n 45, p 221, cited above at n 49.

[116] The term "exculpation" is used here synonymously with ratifying, authorising, forgiving or condoning a breach of duty, as per the commentary in Wishart, above n 36, pp 327 & 328.

[117] Sealy notes that apart from a formal scheme of arrangement, "There is no room in company law to allow for any possibility of ratification by the creditors". See Sealy-Monash, above n 91, p 181.

the relevant company's shareholders had approved the director conduct before the court.[118] The case law, however, appears equivocal. In *Kinsela*, the New South Wales Court of Appeal concluded that exculpation by the shareholders is not possible.[119] In contrast, in *Multinational* the majority of the English Court of Appeal decided that because the shareholders had unanimously approved the actions of the directors, the company could not complain.[120]

It has been suggested that whether exculpation is possible has its roots in the notion of corporate entityhood.[121] For wrongs to the company, the case of *Foss* v *Harbottle*[122] is authority that the proper plaintiff is the company. Nowadays it is considered that the majority of shareholders in meeting have the power to exculpate directors.[123] In this context, three issues are raised by the possibility of exculpation of a breach for the directors' duty to take into account the interests of creditors.

First, is whether there is a ratifiable breach of the duty. It has been suggested that no convincing general definition of what types of breaches are ratifiable has been developed.[124]. The second issue is what is the significance of unanimity amongst the shareholders. Cooke J in *Permakraft*[125] noted that the unanimous agreement of shareholders in matters intra vires the company binds the company. The apparent importance of unanimity to the case law is that, if and when, directors actions have been approved by shareholders, it has been unanimously in each case. It is submitted, however, that unanimity is really a "red herring" as the effect of exculpation should not be affected by whether it is passed by majority or unanimously. It remains approval by one interest group only. Finally, if exculpation is possible is it always available or does its availability vary with the solvency of the company at the time of the decision? In *Multinational* the relevant decisions were made when the company was solvent and the court held the decisions were ratifiable. By contrast, in *Kinsela*

118 See below Part IV - An Analysis Of The Coninued Relevance Of The Common Law Duty Regarding Creditors: Does It Add Anything To The 93 Act?

119 *Kinsela*, above n 45, p 732.

120 *Multinational,* above n 80, pp 268 & 269, 282 and 288 et seq.

121 Wishart, above n 36, p 327. Seealso above Part II Section b Subsection 1 - The orthodox view: exclusively to the company.

122 See above n 121.

123 See K W Wedderburn "Shareholders' Rights and the Rule in *Foss v Harbottle*" (1957) 15 CLJ 194 and (1958) 16 CLJ 93.

124 Wishart, above n 36, p 328.

125 *Permakraft*, above n 59, pp 247-249.

the company was in a state of imminent collapse and the breach of duty was not ratifiable. This apparent conflict can be explained by an examination of the contrasting judicial approaches in the respective cases. It is perfectly consistent with Dillon J's eschewal of a duty to creditors at common law that he endorsed exculpation by shareholders in *Multinational*. Similarly, Street CJ's comments in *Kinsela* are consistent with the court's generally sympathetic approach to a duty to creditors in that case. But to suggest that the common law duty is ratifiable prior to the onset of insolvency, but not after, appears to complicate matters unduly. Conceptually, it seems odd that a duty for the benefit of one interest group could be exculpated by another interest group at any time, but even more so when the groups' interests would be directly opposed, as is the case for creditors and shareholders upon the insolvency of a company. Furthermore, company law is said to have a long record of striking down phoney or self-serving votes by shareholders which have purportedly ratified directors breaches of duty.[126]

5 *What is the source of the duty?*

It may be suggested that the rationale for the duty to creditors conditions its form. Cooke J suggested tort may be an appropriate starting point,[127] but conceptually this appears unconvincing.[128] It is not directors' primary role to take care but to take risks. A duty of care and the liberty to embrace risk are "incompatible bedfellows".[129] Another suggested source has been contract, particularly in the case of salaried directors.[130] There is, however, no privity of contract between a company's creditors and its directors, and no relationship of trust in the traditional sense either. Creditors deal with a company as a matter of bargain and bargain involves risk. The law has traditionally looked askance at attempts in other contexts to infer a trust in a situation which is purely one of debt. It is therefore unlikely that either contract or trust could rightly be considered the basis for the duty. General consensus[131] appears to favour equity as the source of the duty, although such an equitable duty appears limited to one owed to the company. Equity has the advantage of appearing to be a simple

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126 Sealy-Monash, above n 91, p 182. Such cases are usually described as fraud on the minority, or more accurately, fraud on the company.
127 *Permakraft,* above n 59, p 250.
128 See Sealy-Monash, above n 91, pp 176 & 177.
129 Sealy-Monash, above n 91, p 176.
130 Above n 129.
131 See Dabner, above n 40.

extension of previous common law duties, and for this reason it has been suggested that equity appears to be the basis on which most cases were decided.[132] Conversely, it has been suggested that the case law can stand as evidence of the application of statutory prohibitions, i.e., misfeasance being the best example. A further suggested source of the duty is the statutory scheme of creditor protection.[133] The duty created by Tipping J in *Hilton* has been described as a duty by statutory synthesis. However, the duty revolved around the maintenance of capital doctrine, now abandoned by the 93 Act.[134] What perhaps the conjecture surrounding the source of the duty best illustrates is ambiguity surrounding the duty generally. At a minimum the duty is certainly without precise delineation.

E Concluding Remarks As To The Notion Of A Common Law Duty Upon Directors In Relation To Creditors

In summary, this lack of precise delineation of the nature of the duty directors may owe to creditors and the conduct it demands is clearly problematic. Doubt as to when the duty arises similarly begets uncertainty as to what the duty demands. If any conclusion can be drawn, it is that the most important issues concerning the common law duty appear inadequately analysed and poorly developed by the courts. Taking a lowest common denominator approach and expressing the duty merely as the aggregate of those dicta carrying the greatest general level of support and least objection, the following general parameters may be noted. Beyond any real doubt, the duty appears owed to the company alone and at the very least, it arises in situations where the company is insolvent. It prescribes directors consider the interests of creditors, although it is unclear whether this involves subverting the interests of shareholders, much of the judicial comment endorses such an approach once insolvency is pending.

As such, the duty is not one owed to creditors per se, but rather the company. It follows therefore that only the company could action a breach of the duty. This is unfortunate because, as Sealy has noted "A supposed legal duty which is not matched by a remedy is a

132 Wishart, above n 36, p 333.
133 R I Barrett "Directors' Duties to Creditors" (1977) 40 MLR 226, p 229.
134 Wishart, above n 36, p 333.

nonsense."[135] This is not to dismiss the notion of a duty upon directors to consider the interests of creditors summarily, though. Section 301 of the 93 Act permits creditors to apply to the court for orders seeking redress for directors' breaches of duties in relation to the company. Thus statute may provide a lifeline for the continued relevance of the judicial sympathies. But this is to ignore more fundamental shortcomings. The conduct prescribed of directors could best be described as nebulous. No real effort has been made in any of the cases to outline the type of conduct expected of directors by the duty. Moreover, the practical difficulties directors would face in trying to reconcile competing interests are considerable. With respect, Lord Templeman's comment that ".. .a company is not obliged to avoid all ventures which involve an element of risk - but it owes a duty to keep its property inviolable ..." is truly a nonsense. Inherent to the concept of risk is the possibility of failure. The limited liability company as we know it today could not have evolved to its present conception if it had been fettered by such contradictory demands.

135 Sealy-Monash, above n 91, p 177.

III THE COMPANIES ACT 1993 AND STATUTORY BASED DIRECTORS' DUTIES FOR THE BENEFIT OF CREDITORS

A *The Relationship Between The 93 Act And The Common Law As To Directors' Duties*

One of the aims of the 93 Act was to make the content of directors' duties more generally accessible.[136] It has been said the Act is a codification of the duties previously found in the common law and that the duties contained therein are intended to replace any common law duties.[137] Support for this interpretation was provided by removal of clause 116 of the Companies Bill as it was originally introduced to Parliament.[138] Clause 116 expressly provided for the preservation of the existing common law on directors' duties. Its subsequent removal gave strength to the argument that it was Parliament's intention to extinguish those existing principles. It may however be premature to read the 93 Act's silence as to the status of the common law as its "death knell."

For all the talk about codification, the 93 Act does not explicitly state it purports to be a codification. The sections headed "Directors' Duties"[139] stipulate nothing that appears to limit the duties owed by directors to only those provided. The preamble to the Act is similarly vague, stating the 93 Act is intended "[t]o encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment while at the same time providing protection for shareholders and creditors against the abuse of management power."[140] Nowhere is codification mentioned. Moreover, the broad thrust of the duties contained in the 93 Act is to create general standards.[141] It has been suggested, therefore, that the 93 Act will rely for its efficacy on the continuation of a

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136 See Law Commission *Report No. 9 - Company Law Reform and Restatement*, Law Commission, Wellington, 1989, p 44, para 187.

137 A Beck, Chpt 24 "Directors' Powers And Duties" in *Morison's Company and Securities Law* Butterworths, Wellington, looseleaf service ("Beck-Morison's"), p I/111, para 24.7.

138 For the text of the Bill, see CCH *Special Edition - New Zealand Company Legislation*, CCH (New Zealand) Limited, Auckland, 1993, p 88,102.

139 93 Act, sections 131-138.

140 93 Act, Preamble, paragraph (d).

141 See D O Jones *Company Law In New Zealand - A Guide to the Companies Act 1993*, Butterworths, Wellington, 1993, p 113, where the author notes:

> *To refer to this adoption as a "codification" is not entirely appropriate because while the treatment of some aspects of the common law duties appears to be exhaustive (e.g. the duty to avoid conflicts), in large part the duties included in the statute are general standards.*

substratum of common law.[142] Thus, although the intention of the Law Commission who instigated the process that culminated in the enactment of the 93 Act was to "distil the general principles from the cases and express them in the statute"[143] it is far from conclusive that the common law has been superseded. The general nature of the statutory duties[144] provides the judiciary with a wide discretion in the manner in which the duties will be applied to director conduct, and a fortiori, the precedent value of how similarly formulated common law duties were previously applied is unlikely to be readily discarded by the courts.[145] There appears scope indeed for the continued application of common law formulations of directors' duties.[146]

B *Statutory Directors' Duties Provided In The 93 Act For The Implicit Benefit Of Creditors*

The 93 Act does not provide that any of the directors' duties contained therein are owed to creditors. Subsection 169(3) provides certain duties are owed exclusively to either the company or the shareholders, however.[147] The dichotomy established thereby between the company and its shareholders appears to support an argument that the 93 Act endorses an enterprise conception of the company, as opposed to the present associated members. Nevertheless, although no statutory directors' duties are owed explicitly to creditors, the 93 Act undeniably contains duties which must have been intended to benefit creditors. Specifically, these are the duties to refrain from reckless trading[148] and to avoid obligations a director believes the company would be unable to perform.[149] Both these duties are explicitly

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142 See B Harris "Fiduciary Duties of Directors Under the Companies Act 1993" [1994] NZLJ 242, p 245. Harris argues this will be particularly so regarding misuse of information, prejudice to the company from such misuse, and notification of the use of company information.

143 See above n 136.

144 For example, the duty to exercise a power for a proper purpose, provided in the 93 Act, section 133.

145 In this regard, see *Anderson's Company and Securities Law* Brooker & Friend, Wellington, looseleaf service ("*Andersons*"), Part VIII - Directors' Duties, paras 126.01-138.04 and accompanying commentary which provides commentary upon the common law fiduciary duties in the context of the provisions of the 93 Act.

146 For example, 93 Act, subsection 169(3) provides "without limiting subsection (1) of this section, the duties set out in [sections 90, 140 and 148 of the 93 Act] are duties owed to shareholders ...". Subsection 169(1) provides "A shareholder may bring an action against a director for a breach of a duty owed to him or her as a shareholder." Thus, subsections 169(1) and 169(3) appear to anticipate duties other than those provided in sections 90, 140 and 148 being owed to shareholders. There is no reason why such other duties should only be statutory based.

147 See above n 146.

148 93 Act, section 135.

149 93 Act, section 136.

owed to the company as an entity.[150] The following sections discuss the likely parameters of the two duties,[151] drawing largely on offences created by similar 55 Act provisions.

C *The Statutory Duty To Refrain From Reckless Trading*

1 *The 93 Act provision: section 135*

Section 135 of the 93 Act provides:[152]

> A director of a company must not -
>
> (a) Agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or
>
> (b) Cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

2 *55 Act origins: paragraph 320(1)(b)*

Section 135 is very similar to paragraph 320(1)(b) of the 55 Act,[153] which essentially prohibited company officers from knowingly carrying on the business of the company in a reckless manner. It may seem odd section 135 is headed "Reckless Trading" when there

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150 93 Act, subsection 169(3).

151 The author is unaware of any decided case law upon either section at time of writing.

152 93 Act, section 135 replaced a provision proposed by the Law Commission requiring directors not to risk solvency unreasonably.

153 55 Act, section 320 provided:

> **320 Responsibility for fraudulent trading of persons concerned** (1) If in the course of the winding up of a company it appears that -
>
> (a) Any person was, while an officer of the company, knowingly a party to the contracting of a debt by the company and did not, at the time the debt was contracted, honestly believe on reasonable grounds that the company would be able to pay the debt when it fell due for payment as well as all its other debts, (including future and contingent debts); or
>
> (b) Any person was, while an officer of the company, knowingly a party to the carrying on of any business of the company in a reckless manner; or
>
> (c) Any person was knowingly a party to the carrying on of any business of the company with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, -
>
> the Court, on the application of the Official Assignee or the liquidator or any creditor or contributory of the company, may, if it thinks it proper to do so, declare that the person shall be personally responsible, without any limitation of liability, for all or any part of the debts and other liabilities of the company as the Court may direct. On the hearing of an application under this subsection the Official Assignee or the liquidator, as the case may be, may himself give evidence or call witnesses.

appears to be no mention of recklessness in the body of the section whatsoever.[154] Perhaps the most important distinction to make between section 135 of the 93 Act and paragraph 320(1)(b) of the 55 Act is that the former appears to be a duty applicable to all companies at any time, whilst the latter was only available once the company was being wound up.

3 Prima facie meaning of "a substantial risk of serious loss to the company's creditors"

The significant words in section 135 are clearly "a substantial risk of serious loss to the company's creditors." It is apparent this statutory test draws heavily on the antecedent case law under paragraph 320(1)(b). The test adopted by the courts to decide if a director had been reckless for the purposes of paragraph 320(1)(b) under the 55 Act was formulated by Bisson J in the leading case *Thompson v Innes & Anor*[155] as follows:[156]

> *[W]as there something in the financial position of this company which would have drawn the attention of an ordinary prudent director to the real possibility not so slight as to be a negligible risk, that his* ***continuing to carry on the business of the company would cause the kind of serious loss to creditors of the company*** *which section 320(1)(b) was intended to prevent.*

Bisson J's "serious loss to creditors of the company" all but mirrors section 135's "serious loss to the company's creditors." Moreover, given this similarity, it is not unreasonable to suggest Bisson J's "real possibility not so slight as to be a negligible risk" formulation would be adopted by the courts as a proxy for "substantial risk". The duties appear to be objective on both the paragraph 320(1)(b) 55 Act formulation, due to the reference to "ordinary prudent director", and upon the section 135 formulation, due to the objective standard of care imposed on directors exercising duties under the 93 Act by section 137 of the 93 Act.[157] Notwithstanding that a director's subjective belief under section 135 would probably not

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154 A reference to "reckless trading" in the Companies Bill was removed before it was passed. See Beck-Morison's, above n 137, p 123, para 24.16, fn 3.

155 (1985) 2 NZCLC 99,463 ("*Thompson* v *Innes*").

156 Above n [n-1], p 99,472 (emphasis added).

157 93 Act, section 137 provides:

> A director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation,-
> (a) The nature of the company; and
> (b) The nature of the decision; and
> (c) The position of the director and the nature of the responsibilities undertaken by him or her.

excuse a breach of duty, where a director has acted on proper advice the director may be able to avoid liability.[158]

The moment of the words "agree", "cause", or "allow" in section 135 are to redress interpretational problems arising under paragraph 320(1)(b) concerning the meaning of "knowingly".[159] "Allow" would particularly appear to provide the courts with an opportunity to expansively apply section 135 to cover directors who allowed substantial risks to creditors to arise, but who took no active role in the decisions begetting the risk.

4 *Analysis of the elements of the paragraph 320(1)(b) "reckless trading" offence provided in the 55 Act*

For a creditor, liquidator, Official Assignee or contributory of the company to have an action under paragraph 320(1)(b) of the 55 Act, the prerequisite elements of the offence had to be established. The paragraph had the following elements, and the burden of proof, to the civil standard of the balance of probabilities, was upon the person, usually a liquidator, who brought the action:[160]

1. an **officer** of the company
2. who was **knowingly**
3. a **party**
4. to the carrying on of **any business of the company**
5. in a **reckless** manner.

"Officer" was a defined term under the 55 Act,[161] expressly including a director, manager or secretary of the company. The definition was not exhaustive, however, and any person holding a position in the company could be included.[162] Directors were obviously invariably considered officers.

158 93 Act, section 138.

159 For example, the director who did not personally take part in the business of the company, but was content to let other directors incur debts while the company was insolvent.

160 See above n 153.

161 55 Act, subsection 2(1).

162 See A Beck and A Borrowdale *Guidebook to New Zealand Companies & Securities Law*, 4th ed, Commerce Clearing House New Zealand Limited, Auckland, 1990 ("Beck & Borrowdale- 4th ed"), p 43, para 302.

To take the third element out of order, for a person to be a "party" that person "must take some positive and active part in the actual conduct of the business operations of the company."[163] This formulation of "party", although English in origin, was expressly endorsed in New Zealand in the context of paragraph 320(1)(b).[164] It has been said being a party "necessitates some form of positive involvement, not mere inertia"[165] and "what is implicit in the court's finding is that being 'a party to' necessitates positive action with regard to the acts tainted ... but does not include mere participation in the general conduct of the business."[166]

To be "knowingly" a party in the context of paragraph 320(1)(b), it has been said:[167]

> *The word knowingly probably does not require an element of mens rea but is likely to protect officers who have not taken an active part in the management and have no knowledge of the affairs of the company - See* Re J Hurdley and Son Ltd (in liq)...[168]

In *Hurdley*, Ostler and Fair JJ held that parliament's object in using "knowingly" was to protect such members of the company as do not take an active part in its management, and therefore, have no knowledge of the state of its finances. Ostler J said:[169]

> *If a reasonable man at the time that the debt was incurred and with the knowledge of the directors as to affairs of the company would have known that the company was insolvent, and that there was no reasonable chance of its being able to pay the debt incurred together with all its other debts, then, in my opinion the directors are liable ...*

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163 See *In Re Maidstone Buildings Provisions Ltd* [1977] 1 WLR 1085, cited in Anderson's above n 145, Companies Act 1955 Commentary, p 1-580, para Cos 320.07.

164 In *Thompson* v *Innes*, above n 155, Bisson J held, at p 99,470:

> For a person to be a party to the carrying on of a business he must take some positive and active part in the actual conduct of the business operations of the company (see *In Re Maidstone Buildings Provisions Ltd* [1977] 1 WLR 1085). Such positive and active part may take various forms and would include the giving of advice.

165 See Farrar, above n 8, p 22.

166 See G Walker "Directors' Liability For Fraudulent Trading" [1984] 11 NZULR 189, p 197.

167 P Howell and M Whale *Recent Developments In Insolvency Law and Practice*, NZLS Seminar Paper, 1987, p 30.

168 [1941] NZLR 686 ("*Hurdley*").

169 *Hurdley*, above n 168, p 743.

Myers CJ held that "knowingly" did not import mens rea but meant that, before an order can be made, it must be shown that the shareholder of the company sought to be mulcted knew that the particular debts were being incurred and that the shareholder also had a knowledge generally of the company's affairs, so that, as a reasonable person, he or she should have known that, at the time when the particular debts were contracted, the company could not have had any reasonable or justifiable expectations of being able to pay the same as well as its other debts.[170] On the basis on *Hurdley* therefore, it appeared that in order for an officer to be "knowingly a party" he or she had to have actual knowledge of the reckless trading and a general knowledge of the company's affairs. Further, the officer must also have taken an active part in the prohibited act (i.e., the reckless trading) and a mere omission will not make the officer liable.

The meaning of "any business of the company" was discussed by the Court of Appeal in *Re Nimbus Trawling Company Ltd: Keegan and Anor* v *Page Vivian Motors Ltd.*[171] In the case, the court held by a majority[172] that in section 320 the expression "any business of the company" included an isolated transaction even when the transaction was not in the course of carrying on the company's usual business. Thus, section 320 was applicable to the process of carrying out by the company of any transaction which was a business transaction. The majority emphasised that section 320 used "any business" as opposed to "the business", indicating that, in their Honours' opinions, the section did not refer to the totality of the company's activities. Thus, it was sufficient to impose liability, if in the course of business generally, a particular piece of business was carried out with requisite intent.[173]

Recklessness was undoubtedly the most important element of paragraph 320(1)(b). The leading New Zealand case on the topic was *Thompson* v *Innes*. The appropriate test has

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170 *Hurdley*, above n 168, p 734.

171 (1986) 3 NZCLC 99,646 ("*Nimbus*").

172 Cooke P and Somers J, Richardson J dissenting.

173 While on the facts of *Nimbus*, above n , the sale of an asset and the disbursement of its proceeds was not the company's business in the normal commercial sense of trading for the purpose of making a profit, it was held that where the company had ceased trading and engaged in winding up the business was still being carried on by it. Cooke P, at 100,165, stated:

> *... the provision [paragraph 320(1)(b)] covers any dealing or transaction of the company performed, carried out, or conducted with the intention of defrauding creditors ... Remedial legislation of this kind should not be narrowly interpreted.*

already been noted in this paper.[174] However, there are additional aspects to recklessness that should be noted. First, merely because a company was unable to pay its debts as they fell due does not of itself prove recklessness in the carrying on of the company.[175] In *Thompson* v *Innes*, it was noted that many companies experience liquidity problems, but with some forbearance by the creditors they may trade their way out of difficulty. Bisson J, however, continued "there are grave responsibilities on directors who take that course as without reasonable prospects of success, their actions may amount to a reckless disregard for the losses they impose on company creditors."[176] Secondly, in determining recklessness it was necessary to enquire if the conduct was blameworthy.[177] This was an objective test.[178] Thus, the courts were not required to look at the mental state of the particular officer. Blameworthiness to the extent of dishonesty did not have to be proven, however.[179] Finally, the standard imposed by the courts was that of the reasonably competent person in the position of the defendant.[180] It is now appropriate to examine how the courts applied the 55 Act provision.

Application by the courts of the reckless trading offence: The leading cases under paragraph 320(1)(b)

a Thompson *v* Innes

In *Thompson* v *Innes*[181] the company was incorporated in August 1981. Mr and Mrs I were its only directors and shareholder, Mr I working as the principal salesman and Mrs I in the office. By November 1983 the company had gone into voluntary winding up and a liquidator appointed. After its first full year's trading ending March 1983, the company recorded a gross profit of $48,733, but after deducting operating expenses a loss of $1,209 resulted. Accounts from March 1983 to the date of liquidation showed a gross profit of $15,669, but after

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174 See above Part III Section C Subsection 3 - Prima facie meaning of "a substantial risk of serious loss to the company's creditors" and text accompanying above n 156.

175 *Thompson* v *Innes*, above n 155, p 99,468.

176 Above n 175.

177 *Thompson* v *Innes*, above n 155, p 99,470.

178 In contrast, to paragraph 320(1)(a) of the 55 Act, where an honest belief was relevant, for example.

179 *Thompson* v *Innes*, above n 155, p 99,472.

180 See *Re Electronics Business Systems Ltd (in liq)*; *Guzzwell* v *Burr* (1990) 5 NZCLC 66,473 ("*Electronics*"), p 66,477.

181 See above n 180.

deducting operating expenses a loss of $32,253. The later profits were produced on an increased turnover, so that the gross profit margin actually fell from 31% of sales to 13%, whilst sales had increased by $1,300 per month on average. Similarly, the liquidity ratio had deteriorated, so that by November 1983 current assets were $38,442 and current liabilities $66, 293.[182] The liquidator applied for an order under section 320 of the 55 Act declaring the directors personally liable for the debts and liabilities of the company to the extent of $50,700.

In June 1983 Mr and Mrs I met with their bank and F, an accountant and the company's secretary. Estimates of performance to June 1984 were sales of $287,000 and a cash surplus of $12,112. As a result the bank increased its overdraft accommodation to $12,000. Bisson J considered the meeting indicated "a desire with further bank accommodation to trade out of a loss situation and liquidity problems. It could not be said that the directors who had the support of their company accountant were then carrying on the business of the company in an unreasonable manner. I do not regard the bank's small increase to its overdraft facility as significant as the bank was secured to for any advances made to the company under its mortgage over the house property."[183] F, in evidence, was satisfied with the performance estimates for the company, given his knowledge of Mr I as a salesman and said he believed that as at June 1983 the company could have traded its way out of financial difficulties.[184] However, the company never met its sales forecasts in the months after June 1983, and further, purchased an additional vehicle and acquired computer equipment as well as making substantial cash drawings, all against F's advice.

Bisson J found that Mr and Mrs I were intimately involved in the day to day running of the company, both being full aware of its financial position. In contrast, F, played no part in the day to day conduct of the company's business nor did he encourage the directors to carry it on once presented with financial difficulties. As such, only Mr and Mrs I were responsible for carrying on the company's business.[185] The issues was whether their management had been

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182 For the facts of *Thompson* v *Innes* generally, see above n, pp 99,464-99,420.
183 *Thompson* v *Innes*, above n 155, p 99,487
184 *Thompson* v *Innes*, above n 155, p 99,469.
185 *Thompson* v *Innes*, above n 155, p 99,470.

reckless.[186] Bisson J then proceeded to examine the meaning of recklessness for the purposes of paragraph 320(1)(b).[187]

In applying the test to the facts, both Mr and Mrs I were held by the court to be knowingly parties to the carrying on of the business in a reckless manner from the end of September 1983.[188] The crucial evidence was that the sales figures for July, August and September were only 60% of the budgeted forecasts, whilst creditors had nearly doubled. His Honour held the company had clearly been insolvent and unable to pay its debts as they fell due for some months. Although Bisson J accepted that when Mr and Mrs I saw the bank in June 1983 they had reason to believe they could trade their way out of their financial difficulties, the:[189]

> *...situation was nonetheless serious and called for very close monitoring in the light of the budget they had prepared. The rate of decline of the company's trading position was so rapid that by the end of September it should have forthwith ceased trading. The directors must have, or should have, as ordinary prudent directors realised that to continue the business operations of the company any further would cause a serious loss to creditors. No steps were taken to prune expenditure.*[190]

As to the issue of the award, Bisson J declared the directors responsible for $25,000 of the company's debts "having regard to the increase in creditors, the siphoning off of stocks the making of cash drawings and relieving themselves of a personal guarantee to the bank". He gave no guide as to how the factors related to his award, but on the facts it amounted to approximately half the sum claimed by the liquidators. Significantly, His Honour said the directors were to be jointly and severally responsible.

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186 Above n 185.

187 His comments have been dealt with elsewhere in this paper, see above Part III Section C Subsection 4 - Analysis of the elements of the paragraph 320(1)(b) offence provided in the 55 Act.

188 *Thompson* v *Innes*, above n 155, p 99,472.

189 Above n 188.

190 Bisson J was further critical of directors' bechaviour of incuring unnecessary expense (the computer and motor vehicle), and personal drawings, and when money was received it was used to clear the bank overdraft which personally benefited the directors by discharing their personal guarantees. However, he did not consider this amounted to dishonestly. *Thompson* v *Innes*, above n 155, p 99,472.

b *the* Rex Wood *decision*

In *re Rex Wood Service Centre Limited (in liq)*,[191] the company, which had been incorporated in 1978, suffered an unexplained loss of assets between April and May 1981 in the sum of approximately $324,000. In 1983 the company was wound up and a liquidator appointed. The liquidator applied to the court for orders pursuant to section 319, 320(1)(b) and 320(1)(c) of the 55 Act, declaring the company's director, W, personally responsible for an amount equivalent to the total of proved creditors in the liquidation, plus interest. Section 319 of the 55 Act imposed liability upon directors for failure to keep proper accounting records.[192] The liquidator alleged in support of the section 319 claim that bank statements, customer accounts, debtors lists, deposit books, stock lists, invoices and records of goods sold were not kept.[193] On the facts, there were no records to establish how the company had lost the funds in question between April and May 1981. It was held by Doogue J that proper accounting records would have explained the substantial loss suffered by the company.[194] As W was responsible for the lack of records "for that information not to be available, the [director] has acted in such a reckless manner that it is proper and appropriate that an order also be made under section 320(1)(b)."[195] Doogue J saw fit to make an order that W was personally liable for the whole sum owing to creditors in the liquidation, plus interest.

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191 (1987) 3NZCLC 100,199 ("*Rex Wood*")

192 55 Act, subsection 319(1) provided:

> **319(1) Personal resposibility** Subject to subsection (2) of this section, if-
> (a) A company that is being wound up and that is unable to pay its debts has failed to comply with section 151 of this Act (which relates to the keeping of accounting records): and
> (b) The Court considers that-
> (i) The failure to so comply has contributed to the company's inability to pay all its debts or has resulted in substantial uncertainty as to the assets and liabilities of the company or has substantially impeded the orderly winding up thereof; or
> (ii) For any other reason it is proper to make a declaration under this section-
> the Court, on the application of the Official Assignee or the liquidator or any creditor or contributory of the company may, if it thinks it proper to do so, declare that any one or more of the officers of the company shall be personally responsible, without any limitation of liability, for all or any part of the debts and other liabilities of the company as the Court may direct.

193 All of which had to be kept pursuant to section 151 of 55 Act.

194 *Rex Wood*, above n 191, p 100, 207, where Doogue J felt:

> *the particular matter which weighs with me is that the failure of the company to have records, records which, on the evidence, should have been in the possession of [the director] to explain the deficiency in the company's position between 1 April 1981 and 11 May 1981. The reduction in the company's assets...is something which should be disclosed by any proper company records..*

195 *Rex Wood*, above n 191, p 100,207

c Lake Tekapo[196]

The success of the actions in *Thompson* v *Innes* and *Rex Wood* contrasts with an unsuccessful action by the liquidators in *Lake Tekapo*. In *Lake Tekapo* actions were brought against the director of the company, W, who was also the owner of all but one share in the company, under paragraphs 320(1)(b) and 320(1)(c) of the 55 Act, to recover the sum of two capital dividends W had caused to be declared. The background to the case was that the litigation was another episode in a sequence of suits which had taken place between W and other family members, W's parents and his sister, R, over a number of years. In June 1983 a formal deed of settlement was entered into between W, the company, Alpine (another family company owned by W and his sister), R, and W's parents. An essential point established by the deed was that Alpine would pay the company a sum, representing goodwill upon the transfer of the company's business to Alpine, and that sum would become the source of the proposed capital dividend to be declared by the company in W's favour.[197] The first capital dividend was paid in March 1984 in the sum of $152,768. In examining the allegations pursuant to paragraph 320(1)(c), Tipping J commenced by investigating the financial position of the company when the first dividend was paid. On the facts, he was not satisfied the liquidators demonstrated, on the balance of probabilities, that the company was insolvent.[198] In addressing whether the dividend could have been paid in a reckless manner, after examining the meaning of reckless for the purposes of paragraph 320(1)(b),[199] as the company was solvent at the relevant time, Tipping J held W's actions in paying the dividend could not have been held to have been reckless. In his words he did "not think there was anything in the financial position of the company at that time which would have drawn the attention of Mr White as an ordinary prudent director to the possibility that his declaration of this dividend would cause serious loss to creditors or indeed any loss at that time to creditors."[200] However, the position was not so straight forward regarding the second dividend. The liquidators alleged that W had been reckless in ignoring the contingency on an

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196 *Re Lake Tekapo Motor Inn Limited (in liq)* (1987) 3NZCLC 100,156 ("*Lake Tekapo*").

197 The structure was essentially tax driven, as the capital dividend would have been tax free in W's hands, rather than press for a salary payment form the company which would have been taxable. Tipping J considered "...the first capital dividend ultimately paid was in part in lieu of salary which would otherwise have been claimed by Mr White.", *Lake Tekapo*, above n 196, p 100,161.

198 *Lake Tekapo*, above n 196, p 100,167. He found "on a realistic appraisal of its debts incurred and contingent [the company] had a surplus of assets over liabilities of $17,000", above n 196, p 100,166.

199 *Lake Tekapo*, above n 196, pp 100,171-100,172.

200 *Lake Tekapo*, above n 196, p 100,172.

adverse judgment against the company from litigation with Alpine, and further that W had preferred himself to other creditors of the company.[201] Tipping J rightly pointed out W was not a creditor of the company in relation to the capital dividend, but noted the essence of the liquidators submission was that W had looked after his own interests with no regard for the creditors of the company, and was thus arguably reckless. At the time of the second dividend in September 1984 the company was, on the facts, insolvent.[202] But on the evidence Tipping J was not convinced it had been established the second dividend was made in reckless disregard of the Alpine claim or the position of creditors generally.[203] His Honour was satisfied W was truthful when he indicated that in declaring the second dividend all he was doing was implementing the arrangement set out in the deed of settlement with his family. Tipping J looked to the substance of the dividend noting the funds distributed were value from two properties that were sold and which the deed had provided were to become W's personal property.[204]

The final aspect of the case was the argument that if W had been liable, he could have relied on section 468 of the 55 Act. Tipping J noted the section only applied if the court was satisfied the director had acted honestly or reasonably, and noted "in cases where a person has been found to have acted recklessly it would seem to me to be unlikely that he could also be found to have acted reasonably."[205]

d *the* Electronics *case*

In *Electronics*,[206] W who became a director of the company in early 1982, had overvalued stock figures for the company and understated its trade creditors. The liquidator of the company bought an action against W under sections 319, 320 and 321 of the 55 Act alleging that W and another director B (who settled with the liquidator out of court) had failed to keep

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201 Above, n 200.

202 *Lake Tekapo*, above n 196, p 100,170.

203 *Lake Tekapo*, above n 196, p 100,173.

204 *Lake Tekapo*, above n 196, p 100,173 per Tipping J:

> *...the second dividend was in substance a payment reflecting part of funds derived from the [two properties'] sale,and thus validly in Mr White's mind simply a further step in getting their value into his own hands as had been implicit in the settlement negotiation and its terms.*

205 *Lake Tekapo*, above n 196, p 100,174.

206 See above n 205.

property accounting records and had carried on the business of the company in a reckless manner.

More particularly, the background facts to the case are as follows. In August 1981 the company's business showed a loss of $69,828.[207] The company's accountant prepared financial forecasts in September 1981 showing sales of $45,000 per month would be necessary to break even. During the next four months that volume was not achieved and the company operated at a loss of $23,961 to the end of December 1981. The company continued to trade during 1982 and B prepared a set of accounts that showed a net profit of $46,876 for the six months to June 1982. A further set of account for the nine months to September 1982 showed a loss of over $10,000. This caused B to have an independent check made on the stock figures. The check showed stock had been considerably overvalued and trade creditors understated, in the June 1982 accounts. As a result of the check it was shown the company's liabilities exceeded its assets by approximately $183,000. The company then went into voluntary winding up and a liquidator was eventually appointed.[208]

Evidence disclosed that although B had assumed responsibility for the day to day financial affairs of the company, in relation to the stock figures, B was dependent upon information supplied to him by W, who personally attended to the company's stock takes. W was found to have been well aware of the significance of stock valuation for profitability. Ongley J held that W's stocktaking was not in accordance with the standard expected of a reasonably competent retail manager, and that W "knew or should have known that the system of stocktaking developed by him would result in a false position as to profitability of trading the company's asset position as shown in its accounts."[209] From the beginning of 1982 W should have been aware that the company was trading at a loss and that to continue trading would involve the company's creditors in the risk of financial loss. Thus, Ongley J found W

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207 The company had been trading its business as agent for a partnership which was dissolved following the August 1981 loss, as the loss all but extinguished the partnership capital. The business was transferred to the company in September 1981. The balance sheet for the company when it started trading as principal had zero equity, its assets and liabilities each totalling $337,550. See *Electronics*, above n 180, pp 66,475 - 66,476.

208 For the facts of *Electronics* see above n 180, pp 66,474 - 66,477.

209 *Electronics*, above n 180, p 66,477.

knowingly was a party to the carrying on of the business of the company in a reckless manner from 1982 onwards.[210]

The final aspect was the amount of the declaration. Ongley J noted that what part of company's liabilities that could be attributed to W's recklessness depended in part as to when the company should reasonably have been wound up. On the fact, His Honour thought the end of 1981 was the very latest this should have occurred. At that stage, the trading losses of the company were $23,961, so Ongley J reasoned the loss attributable to the reckless trading was the final deficiency upon liquidation owing to creditors of $169,629 less $23,961.00, or $145,668.[211]

6 *Suggested parameters of the 93 Act's section 135 duty regarding reckless trading*

Due to the close similarity between section 135 of the 93 Act and paragraph 320(1)(b) of the 55 Act, it is submitted the case law decided pursuant to the former provision will continue to be utilised by the courts in determining cases under the new provision. As noted, the most apparent difference between the two provisions is when each would operate. Paragraph 320(1)(b) clearly only operated upon winding up, although its retrospective application had the effect of impugning conduct prior to winding up. By contrast, there is no such limitation upon the operation of section 135. It is suggested this difference will not be of great significance. Obligations to creditors, be they expressed in terms of a duty or otherwise, only become meaningful in times of financial hardship. In times of profitability, when creditors are being paid in the normal course there is no need or incentive for a creditor to seek redress from the debtor company's directors: there is no prejudice to them.

A further divergence between the provisions is the requisite degree of knowledge a director require before liability would be imposed. Under the 55 Act, the requirement that an officer be "knowingly a party" to the misconduct meant, on the authority of the *Hurdley* case, that the director had to have, first, actual knowledge of the reckless trading, and secondly, a

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[210] Procedurally, Ongley J was of the view that the case under section 319 of fialing to comply with section 151 of the 55 Act should be subsumed in the allegations of carying on the business of the company in a reckless manner in contravention of paragraph 320(1)(b). *Electronics*, above n 180, p 88,977.

[211] As B had settled out of court for $59,876.32, and Ongley J assumed, without knowing, that figure was a fair estimate of B's responsibility, W was orded to pay the liquidator $85,792.60.

general knowledge of the company's affairs. Section 135 uses the terms "agree", "cause" and "allow", by contrast. In particular, "allow" would appear to provide the courts with an opportunity to impugn directors who, through lack of enquiry, were unaware of the actual reckless trading but stood by as it occurred. For example, the company secretary in *Thompson* v *Innes* may be liable under section 135 because he allowed the company to trade recklessly, notwithstanding he played no part in the day to day running of the company's affairs and did not encourage the company to trade on once it entered financial difficulties, whereas in the case he escaped liability under paragraph 320(1)(b).

The next issue is the significance of the terminology "*the* business of the company" used in section 135 as opposed to "*any* business of the company" used in paragraph 320(1)(b). Under the latter formulation, the Court of Appeal in *Nimbus* stipulated it included isolated transactions outside the company's usual course of business. The court's reasoning specifically focused on the importance of the use of "any". In doing so, the court suggested use of "the" has connotations of the totality of a company's business. The effect of this difference is arguably to exclude one-off transactions. On balance, it is submitted the courts would be unlikely to adopt such an interpretation, for much the same reasons as the Court of Appeal included isolated transactions under the 55 Act: namely, the remedial nature of the provision. As Cooke P noted in relation to paragraph 320(1)(b) "Remedial legislation of this kind should not be narrowly interpreted".[212]

Finally, what is meant by "substantial risk of serious loss to the company's creditors"? From Bisson J's test in *Thompson* v *Innes*, it is submitted "substantial" would be ascribed the "real possibility not so slight as to be a negligible risk" formulation therefrom. But what will this mean in practice? If the cases decided under paragraph 320(1)(b) of the 55 Act are indeed used as precedents for section 135, as it is suggested they should be, then certain proscribed conduct can be identified. The plainest circumstances where directors will be in danger of breaching section 135 are akin to those in *Thompson* v *Innes* where the company traded on after it failed to meet break-even sales performance targets. From the same case, a failure to closely monitor the financial performance of a company when it is barely solvent may also contravene the new provision. Bisson J suggested weekly meetings of directors in such

212 *Nimbus*, above n 171, p 100,165.

circumstances would be appropriate. It is submitted directors would be unwise to ignore this dictum. In a like vein, a failure to keep adequate financial accounts will, on the basis of *Rex Wood*, be a breach constituting reckless trading. Similar conduct likely to impugn the new section would also include employing misleading or inappropriate accounting procedures, as happened in the *Electronics* case. Lastly, it is submitted the precedent value of the *Lake Tekapo* decision must be limited by the demise of the capital maintenance doctrine in the 93 Act, and the protection now afforded to distributions by the solvency test. Much more apparent breaches of the 93 Act[213] will occur where companies declare dividends whilst unable to comply with the solvency test.

D The Duty To Avoid Imperformable Obligations

1 Section 136

The 93 Act, section 136 provides:

> A director of a company must not agree to the company incurring an obligation unless the director believes at the time on reasonable grounds that the company will be able to perform the obligation when it is required to so.

2 The prototype 55 Act offence and its apparent differences to section 136

Prima facie, section 136 of the 93 Act has more than a passing resemblance to paragraph 320(1)(a) of the 55 Act which placed civil liability upon company officers for unreasonably incurring debts.[214] However, section 136 appears to differ in three basic respects. First, section 136 relates to the incurring of an obligation. This is wider than the equivalent wording under paragraph 320(1)(a) of the 55 Act which related to the contracting of debts. The former phrase would include, for example, the provision of goods and services.[215] Secondly, section 136 only requires a belief *the* particular obligation will be able to be performed when required. By contrast, the former paragraph 320(1)(a) required a belief the

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213 For example, 93 Act, section 56 "Recovery of Distributions" would impugn dividends declared in circumstances where the company could not comply with the solvecy test.

214 See above n 153.

215 See Anderson's, above n , p I-171, para 136.04.

particular debt, at the time it was contracted, was capable of payment *together* with all other debts (including future and contingent debts). Finally, the scope of section 136 is broader, applying to a director at any time, unlike paragraph 320(1)(a) which only became applicable to directors upon the winding up of the company.[216]

3 *The elements of the paragraph 320(1)(a) offences: unreasonably incurring a debt*

Paragraph 320(1)(b)[217] could be broken down into the following elements:

1. an **officer** of the company
2. who was **knowingly**
3. a **party**
4. to the **contracting of a debt** by the company
5. and **did not**, at the time the debt was contracted **honestly believe on reasonable grounds that the company would be able to pay the debt** when it fell due for payment as well as all its other debts (including future and contingent debts).

The comments made upon the first three elements of officer, knowingly and a party, in relation to the paragraph 320(1)(b) offence,[218] are equally applicable to paragraph 320(1)(a). For example, in the context of the latter offence, to be "knowingly a party" to contracting a debt, the officer of the company must have actual knowledge of the incurring of the particular debt and also a general knowledge of the company's affairs.

If the liquidator could prove the first three elements, to make an officer liable, the liquidator then had to prove the absence of an honest belief on reasonable grounds that the company would be able to pay the debt when it fell due for payment, as well as all its other debts existing as at when the debt in question was incurred.[219] This element could be satisfied by the liquidator either, first, establishing the absence of an honest belief on the facts, or secondly and alternatively, by showing that although such a belief was present, it was not

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216 See above n 153.
217 See above n 153.
218 See above Part III Section C Subsection 4 - Analysis of the elements of the paragraph 320(1)(b) reckless trading offence provided in the 55 Act.
219 See *Re Petherick Fashions Ltd* (1986) 2 BCR 177; (1987) 2 NZCLC 99,946 ("*Petherick*"), per Eichelbaum J.

based on reasonable grounds. Reasonable grounds was assessed relative to the standard of a reasonably competent officer of the company in that position.[220]

Thus, there was both subjective and objective elements to the test under paragraph 320(1)(a). The subjective element was whether the officer of the company had the honestly held belief. The objective element was that, if the officer did, was it reasonable in the circumstances for the officer to hold the belief.

This composite test of paragraph 320(1)(a) appears reproduced in section 136. Again there must be the subjective belief that the company could perform the obligation when called upon to do so, fettered by the objective requirement of reasonableness. Factors which could be evidence of reasonableness would presumably include management accounts and professional advice confirming the company's viability.[221]

4 *Prominent paragraph 320(1)(a) cases: judicial application of the unreasonably incurring a debt offence*

a *the* Petherick *case*

One of the leading decisions under paragraph 320(1)(a) is *Petherick*.[222] The company was incorporated in April 1980 to take over the business of a clothing shop. P became the sole director and owner of 99.95% of the company's shares in April 1981. The accounts to the end of March 1981 showed the company to be in financial difficulty, having made losses for nine months, but improvement for the next three. Petherick injected more capital and sales rose for a while, but then fell away. By June 1982 the company was in deep trouble and had adopted the practice of writing cheques to pay trade creditors and holding them until funds were available to meet them. A letter was sent to creditors explaining that there had been a downturn in sales but that the situation was temporary. The company also attempted to cut expenses and restrict its purchases of trading stock. However, sales continued to fall, and

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220 *Petherick*, above n 219. The case is authority that if the belief could be said to be a fanciful hope, it was not reasonable.

221 93 Act, section 138 provides a director when performing duties as a director can rely on prepared reports or other professional advice.

222 See above n 221.

after section 218 notices[223] were served, the company was ordered to be wound up in December 1982. The liquidator applied for orders pursuant to sections 320 (paragraphs 320(1)(a), (b) and (c)), 321 and 364 of the 55 Act. In total there were nine claims made by the liquidator against P totalling $123,119, of which the largest was unaccounted for trading stock or sales of $85,000.[224]

In introducing his discussion of subsection 320(1) generally, Eichelbaum J noted the subsection provided the court with jurisdiction to lift the shield of limited liability provided the various elements of either one of its three paragraphs could be made out.[225] The first element the liquidator had to establish was whether P was knowingly a party to the contracting of a debt by the company. On the facts, it did not present a problem, notwithstanding that a manageress had the day to day running of the shop, as Eichelbaum J was satisfied that at all relevant times P was in overall control and that any ordinary orders for stock were made with his knowledge and authority.[226] The liquidator then had to prove absence of the requisite honest belief.[227] From a conceptual point, Eichelbaum J analysed liability under both paragraphs 320(1)(a) and 320(1)(b) simultaneously in his judgment,[228] (although this commentary only focuses upon his findings in relation to the former).

By some date around the middle of 1982, Eichelbaum J said he was convinced the position had been reached where any further liabilities incurred were undertaken on the basis that P did not honestly believe on reasonable grounds that such a debt could be met when it fell due, together with all the other debts of the company, both the honest belief and the reasonable grounds being absent. Significantly, His Honour noted there were two difficulties facing a liquidator, wanting to base a specific recovery.[229] They were, first, the time at which all the elements were present, and secondly, the amount recoverable.

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223 Under the 55 Act, a section 218 notice was the equivalent of the statutory demand contained in section 289 of the 93 Act.

224 *Petherick*, above n 219, pp 178-189; 99,947-99,956.

225 Eichelbaum J also saw fit to endorse the comments of Bisson J in *Thompson* v *Innes* that the three paragraphs of subsection 320(1) provided a gradation of conduct sufficiently blameworthy to pierce the shield of limited liability and to render a director personally liable for all or any part of the debts and other liabilities of the company. *Petherick*, above n 219, p 190; 99,957.

226 *Petherick*, above n 219, p 191; 99,958. No argument was made to the contrary.

227 See above Part III Section B Subsection 3 The elements of the paragraph 320(1)(a) offence: unreasonably incurring a debt.

228 *Petherick*, above n 219, pp 191-193; 99,958-99,960.

229 *Petherick*, above n 219, p 192; 99,959.

With regard to the first, the onus of proof was with the liquidator on the balance of probabilities.[230] On the facts, there was evidence to show April and May 1982 sales ran at considerably higher levels than those previously, or subsequently too. For the company to get out of difficulty, those levels would have had to have been not just maintained, but improved upon. However, having specific regard to the balance of proof, Eichelbaum J said he could not feel confident that it could be said P knew the company would be unable to pay its debts when due, or that there was an absence of reasonable grounds. His Honour particularly, rejected an argument of the liquidator that after the company's accountant had prepared draft accounts as at 31 December 1980, after nine months' trading, which revealed an unsatisfactory position,[231] thereafter all the company's activities infringed paragraph 320(1)(a). The earliest piece of evidence that could establish grounds was the cheque writing procedure from 20 June 1982.[232] Thus, P was liable on and after that date.

The second problem facing the liquidator was the amount recoverable. Eichelbaum endorsed the following general principles.[233] First, the amount of the declaration is in the discretion of the court and should be in respect of a specific sum. Secondly, the amount ordered to be paid would generally be limited to the amount of the debts of the creditors proved to have been defrauded by the acts of the director. Thirdly, the money recovered by the liquidator under the court's order forms part of the assets of the company, available for all creditors in the winding up.[234] Further, he added, "the order should relate and be limited to those debts incurred in the absence of honest belief, on reasonable grounds, that the company would be able to pay them as they fell due."[235] In exercising the discretion of the court, Eichelbaum J considered three factors were relevant:[236] causation, culpability and duration.[237] Regarding causation, generally the quantum of any declaration would be limited to the amounts of those debts the defendant director had knowingly been a party to the contracting of, in the absence

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230 Above n 229.

231 Over the nine months, the company had lost $6,214, and stock, at under $26,000, was less than trade debts. *Petherick*, above n 219, p 178; 99,947.

232 In *Petherick*, above n 219, p 192; 99,959, Eichelbaum J commented:

> *The state of affairs which forced that expedient and which must have been apparent to Mr Petherick clearly demonstrated the absence of reasonable grounds for a belief that the company could pay its debts as they fell due, however elastic a meaning that last expression was given.*

233 The principles were initially formulated by Bisson J in *Re Casual Capers Ltd* [1987] 1 BCR 423.

234 *Petherick*, above n 219, p 192; 99,960.

235 Above n 234.

236 Endorsing the comments of Tompkins J in *Maloc Construction Ltd* v *Chadwick & Ors* M 13/83, New Plymouth, 11 June 1986; (1986) 2 BCR, a case concerning section 319 of the 55 Act.

237 *Petherick*, above n 219, pp 193-194; 99,960-99,961.

of the requisite honest belief.[238] As to culpability, the court could have regard to the culpability of the officer for the failure to comply with the law, i.e., to the extent to which the failure was caused by the actions or inactions of the officer. Eichelbaum J, however, thought that element was of little relevance on the facts of *Petherick*, given that only P could have been responsible for the outcome. He noted it would be of relevance where there was more than one director possibly culpable for the failure.[239] Finally, duration was said to coincide largely with causation on the facts.[240]

However, the real problem with assessing the amount recoverable was not so much conceptual (the foregoing concepts are relatively obvious) but evidentiary.[241] The crux of His Honour's enquiry regarding the appropriate award was: "in essence then I am concerned to establish debts incurred in the period 20 June to 22 August [1982, when the section 218 notice was served]."[242] Average purchases by the company from 1 April to 8 December 1982 were $21,000 per month, but the earlier months of that period were much higher on the facts. With regard to the problematic state of the evidence, and bearing in mind a need to err on the side of caution, Eichelbaum fixed the quantum of liability at $15,000.[243] Finally, although it was noted that it was possible to award punitive damages under paragraph 320(1)(a), the facts of the case did not merit it.[244]

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238 Eichelbaum J referred favourably to the following comment from Tompkins J in relation to section 151 of the 55 Act from *Maloc Construction Ltd (in liq) v Chadwick & Ors* (1986) 3 NZCLC 99,794, p 99,809:

> *There must be a causative connection between the failure and the inability to pay the debts or the substantial uncertainty as to the assets and liabilities or the substantial impediment to the winding up of the company. It follows from that that in exercising the discretion regard should be had to the causative effect of the actions or inactions of the officer, that is, the extent to which those actions or inactions have contributed to the failure to comply and to the consequence on the position of the company at liquidation resulting from that failure. In considering what part of the debts should be included in the declaration the extent of the loss resulting from the failure to comply with sec 151 may, in some cases, be decisive. But where, as here, the ground upon which the declaration is made is substantial uncertainty as to the assets and liabilities of the company that very uncertainty may make it impossible to assess with any precision the effect of the failure to comply.*

239 *Petherick*, above n 219, pp 193-194; 99,960-99,961.

240 Duration would be relevant to an award under paragraph 320(1)(b), however, where it would be wrong to make a director liable for a portion of the company's debts owing at liquidation, where the director was responsible for the business being carried on recklessly although no further debts were incurred. See *Petherick*, above n 219, p 194; 99,981. With all respect to Eichelbaum J, it is hard to imagine a situation where a company will have been carried on recklessly but no further debts incurred.

241 Eichelbaum J maligned:

> *No doubt the liquidator has done his best but one would have wished for more detailed information regarding the fortunes of the company at various stages. In between balance dates, one has to make do with such scraps of information as are available.*

See *Petherick*, above n 219, p 179; 99,948.

242 *Petherick*, above n 219, p 195; 99,962.

243 Above n 242.

244 Above n 242.

b Vinyl Processors[245]

In *Vinyl Processors*, the company had five directors: S and H who were full time employees also, and C, B and K who were non-executive and professional chartered accountants. In June 1984, draft accounts showed the business had made a loss to year end March 1984 of $124,803. The directors, although knowing the company was in a difficult trading position, decided to keep trading. The directors met approximately monthly, and at their next meeting in August 1984 accounts for April to June 1984 showed another loss. At meetings in September, October and November 1984 the directors knew sales targets for 'break even' trading were not being met. The directors then decided to try and introduce a business partner (new shareholder) to improve liquidity, and concentrated most of their efforts on attempting to keep the business going so it (or part of it) could be sold as a going concern. The directors met next in May 1985, their efforts at selling the company being unsuccessful. Receivers were appointed in May 1985 and a liquidator in November 1985. The liquidator brought proceedings under paragraph 320(1)(a) of the 55 Act, seeking declarations that the directors were personally responsible for all or part of the company's debts and liabilities incurred between June 1984, when the directors first learnt of the trading loss for the previous financial year, and April 1985, prior to the receiver being appointed. For the directors it was argued they should have relief pursuant to section 468 of the 55 Act[246] on the ground they had acted reasonably.[247]

Hillyer J in the High Court agreed with counsel that *Petherick* was the leading case on section 320 and endorsed the principles enunciated by Eichelbaum J as to its interpretation.[248] On the facts, it was apparent from at least June 1984 that the company was generating insufficient funds from which to meet its outgoings. Counsel for the directors argued that although

245 See *Vinyl Processors*, above n 1.

246 55 Act, subsection 468(1) provides:

> **486(1) Relief from liability** If in any proceeding for negligence, default, breach of duty, or breach of trust against an officer of a company or a person employed by a company as auditor (whether he is or is not an officer of the company) it appears to the Court hearing the case that that officer or person is or may be liable in respect of the negligence, default, breach of duty, or breach of trust, but that he has acted honestly and reasonably, and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty, or breach of trust, that Court may relieve him, either wholly or partly, from his liability on such terms as the Court may think fit.

247 See *Vinyl Processors*, above n 1, pp 417-428; 34-45 for the facts of the case generally.

248 *Vinyl Processors*, above n 1, p 420; 37.

liabilities were being incurred, creditors were giving credit, in normal cases for a month following the 20th of the month of delivery and in other cases for 60 days following the 20th of the month. However, the court considered that financial data showed the company's position dramatically deteriorating, and notwithstanding this deterioration the company continued to incur substantial debts. Indeed the use of accounting data in the case was considerable. The liquidator produced a schedule of the 'liquidity deficit'[249] for the months of July 1984 to April 1985, which showed the company had liquidity deficits of between -$17,320 in June 1984 and -$108,574 in April 1985, reaching a low of -$246,774 in February 1985. A witness for the directors referred to the 'net trade credit ratio'[250] as a means of assessing the ability of the company to meet its obligations. From September 1984 to April 1985, the net credit ratio was invariably less than one, demonstrating in Hillyer J's words "at no time during that period could the company pay its debts as they became payable from the accounts receivable."

Ultimately, Hillyer J decided the directors should have ceased trading after the end of November 1984.[251] Why November 1984 was chosen and not earlier was not made clear by His Honour. It was probably to do with the pattern of trading and directors' meetings, however. In September 1984, the directors decided the company would continue to trade if sales exceeded $200,000 a month (the figure previously recognised as a break even sales target) and the August 1984 sales figure was $272,765 thus more than breaking even. However sales for September and October 1984 were both below $200,000 and at the directors' meeting of November 1984 a decision was made to find a new partner for the company. The next scheduled meeting was never held which prompted Hillyer J to comment "I would have thought that with the desperate situation that the company was in it would have

249 Liquidity deficit was calculated as a formula A - B + C - D - E - F, where:

- A were the debts owing at the close of the month
- B were the unpresented cheques at the close of the month
- C was utilised bank overdraft available
- D were the creditors incurred during the month
- E was monthly commitments, and
- F the adjustment for creditors out of the purchases journal being cheques not drawn until the month following due date.

See *Vinyl Processors*, above n 1, p 421;38.

250 The net trade credit ration was the ratio of accounts receivable to accounts payable, i.e., if accounts receivable and accounts payable were equal, the ratio would be one.

251 *Vinyl Processors*, above n 1, p 428; 44, where Hillyer J noted:

> *Bearing in mind the hope that springs eternal with the directors in a company which is facing hard times, I have come to the conclusion that the very latest the directors should have continued trading was the end of November 1984.*

been a matter of vital concern to all directors to meet and make decisions without delay".[252] Indeed, the accountant called by the directors noted the October-November 1984 period was "really the crunch",[253] which appears to have influenced Hillyer J in reaching his finding. On the facts, it was estimated from the available accounting information that the debts incurred by the company between the end of November 1984 and commencement of the receivership were $194,154.

In making his determination, Hillyer J reiterated the burden of proof upon the liquidator was on the balance of possibilities, although regard should be had for the serious consequences of liability for the directors.[254] And, in this regard, no distinction was to be drawn between the non-executive and executive directors. Counsel for the non-executive directors submitted section 320 was not designed to protect creditors as a whole, but rather related to the contracting of particular debts, and on the facts, the non-executive directors had no particular knowledge of the incurring of trading debts. Hillyer J firmly rejected the argument noting:

> *That sort of approach ... in my view would totally nullify what I consider to be the intended effect of the section ... If the section applied only to individual debt of which a director had personal knowledge, the section could not operate. It is clear in my view that the section does cover the action of directors approving the incurring of debts in the ordinary conduct of a business. It obviously would not cover any extraordinary debt incurred by management that the directors would not expect, but the debts that have been made are the sort of debts the directors must have expected would be incurred.*

The final issue was the quantum of the liability of the directors. Hillyer J, however, noted "I do not think ... that a simple calculation of the way in which debt has been incurred after a particular point is necessarily the proper way to arrive at the amount to be fixed under the section",[255] and he emphasised the discretionary nature of the award, notwithstanding the considerable amount of financial data available.[256] Although, at least four different methods

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252 *Vinyl Processors*, above n 1, p 425; 41.

253 Above n 1.

254 Regarding the burden of proof, Hillyer J noted, *Vinyl Processors*, above n 1, p 428; 44:

> *... it is not a criminal allegation that as being made which must be proved beyond reasonable doubt. It is, however, an extremely serious allegation, and, as with any civil cases, the proof, while being on the preponderance of probabilities must still have regard to the serious nature of consequences for the defendant.*

255 *Vinyl Processors*, above n 1, p 429; 46.

256 Hillyer J noted of Tompkins J in *Maloc Construction Ltd v Chadwick Lovegrove & Burr* (1986) 2 BCR 217, *Vinyl Processors*, above n 1, p 439; 47:

of quantifying the award were noted,[257] His Honour appeared to ultimately eschew a strict formulation, finding a figure of $180,000 appropriate. Moreover, the five directors were severally liable for the figure, but not, and significantly, jointly and severally liable, "because I do not consider that any one director should have to pay more than his share of the responsibility if any other director is unable to bear it."[258]

Finally, there was no relief for the directors under section 468 of the 55 Act,[259] as relief can only be granted under that section if the director behaved reasonably, and His Honour held a finding against a director under section 320 would prohibit a grant of relief under section 468.

5 *The duty to avoid imperformable obligations: suggested parameters*

It is first opportune to contrast paragraph 320(1)(a) with section 136. The most obvious difference is that section 136 will theoretically apply at any time. However, as with section 135 it is submitted this will be of little moment due to the circumstances in which section 136's beneficiaries, i.e., creditors[260] would have any incentive to try and invoke it. The next difference is the change in terminology from "debts" to "obligations". On a literal interpretation "obligations" appears the broader term, possibly encompassing, for example, goods or services.[261] It is yet to be seen whether the courts will take an expansive approach to interpreting section 136. Theoretically the section has the potential to afford greater protection to those it is designed to benefit than did paragraph 320(1)(a), but as financial

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> *He, however, did not have the benefit of the detailed and careful information that has been put before me as to an accountant's calculation ... of the amount of the deficiency .... Nevertheless, I think it still becomes a matter in which the Court's discretion must be exercised.*

257 For example, the following methods were quantified:
(a) the total loss basis: the total loss suffered by unsecured creditors as a result of the liquidation, being the fund deficiency regarding directors;
(b) Marginal total loss: the difference between the surplus which would have been available had the liquidation taken place when the directors should have stopped trading and the surplus actually available;
(c) Individual marginal loss: the loss suffered by creditors on an individual basis being the difference between the distribution they could expect from liquidation; and
(d) Marginal charge net trade credit: the marginal change in the net trade credit deficiency between when the directors should have stopped trading and when they did.

258 *Vinyl Processors*, above n 1, p 430; 47.

259 See above ~~[quote s. 468 55 Act]~~ n 246

260 The duty contained in section 136 is owed strictly to the company, however: see 93 Act, subsection 169(3).

261 Conceptually it is difficult to see how a consumer of a good or service to be provided by the company could have standing to enforce the duty, however. The available means by which creditors may enforce the remedy, section 301 of the 93 Act, is only available to "the liquidator or a creditor or shareholder"(section 301). It would be considerably stretching the language of the provision to describe such consumers as "creditors" in this context.

to interpreting section 136. Theoretically the section has the potential to afford greater protection to those it is designed to benefit than did paragraph 320(1)(a), but as financial solvency is the ultimate barometer of corporate health it is submitted the new terminology will not significantly alter the nature of the provision from an essential focus upon financial obligations. Furthermore, Hillyer J's comments in *Vinyl Processors* may limit the scope of "obligations" in circumstances where directors have delegated management of the company, when he said paragraph 320(1)(a) "would not cover any extraordinary debt incurred by management that the directors would not expect...".[262] Possibly section 136 will not, therefore, impose a duty on directors where their company has incurred an unusual obligation at the behest of management without the directors' knowledge which the company has been unable to perform.

The final textual difference is the nature of the directors' belief required. A director governed by the 93 Act must believe the obligation can be performed when it is required to do so. Officers under the 55 Act had to believe the debt at issue and all other debts of the company could be paid when due. In practice, it is submitted, this may be significant. If a director under the 93 Act has her or his company incur an obligation that the director knows the company could perform but only at the expense of an obligation already incurred, this is arguably a sufficient belief for the director to avoid liability. On balance though, it is unlikely a court, while recognising this subjective belief, would find it reasonable in the circumstances. It must surely be implicit in section 136 that the company's ability to perform the obligation is contingent on it being able to perform all its other obligations also.

These differences aside, what director behaviour is likely to be impugned? The crux of the section, for any party seeking to invoke it, will obviously be the sorts of grounds that will objectively rebut a subjective belief held by a director. From the cases decided under paragraph 320(1)(a) it is clear that continuing to incur debts whilst insolvent in a balance sheet sense will not of itself suffice. Rather consistent liquidity insolvency is likely to occasion a breach of the duty. For example, *Vinyl Processors* demonstrates, as did *Thompson v Innes* in the context of reckless trading, that continuing to incur obligations in the light of ongoing failure to meet necessary revenue targets, e.g., monthly sales targets, will probably

262 Above n 255 .

to incur debts whilst insolvent did not per se breach paragraph 320(1)(a). However, the reliance upon accounting records, in *Vinyl Processors* especially, shows the courts' readiness to examine such information in determining the reasonableness of the director's belief concerning the incursion of debts in the circumstances. Moreover, proving the absence of such subjective belief will not be easy. In *Petherick*, only overt behaviour evident of the lack of belief sufficed, e.g., the practice of writing cheques to pay creditors and not sending them when due but waiting until sufficient funds had been received by the company to meet the cheque.

E Remedies Under Sections 135 And 136, Potential Orders And Director Relief

Remedies for a breaches of the duties contained in sections 135 and 136 include the standard injunction where the course of action has not been completed,[263] and an action by the company directly or by shareholders derivatively,[264] where losses have been suffered, although the possibility of either seems remote prior to liquidation. [265] Neither of these remedies would in reality be available to creditors, however. Injunctions may only be applied for by the company, a director or shareholder or an entitled person.[266] Similarly, an action by the company would require director approval. Thus, for those that will be most concerned with the breach, the creditors, their only remedy will be pursuant to section 301 of the 93 Act once the company is placed in liquidation.[267] Once in liquidation, a creditor could have standing to apply to the court to have the director repay the creditor for company property lost via the director's breach of duty.[268] Section 301 of the 93 Act is largely equivalent to the previous section 321 of the 55 Act, which was used to action behaviour typically grouped under the title "director misfeasance", although the reference to the same has long since disappeared from the provision. Thus from the practical viewpoint of available remedies, notwithstanding that both sections 135 and 136 purport to be owed continuously, given that they are substantively for the benefit of creditors, creditors appear little better off than they

263 93 Act, section 164.
264 See 93 Act, sections 165-168.
265 As noted, section 136 is one of the duties explicitly owed to the company and not shareholders; 93 Act, subsection 169(3).
266 93 Act, subsection 164(2). An entitled person mean a shareholder or a person whom the company's constitution confers the rights and powers of a shareholder; 93 Act, subsection 2(1).
267 93 Act, section 301 enables the court to order directors or others to repay misapplied company property.
268 93 Act, paragraph 301(1)(c).

notwithstanding that both sections 135 and 136 purport to be owed continuously, given that they are substantively for the benefit of creditors, creditors appear little better off than they were previously under the 55 Act, as both regimes only permit creditor redress in circumstances of liquidation.

As noted, any action by creditors will be pursuant to section 301 of the 93 Act. Section 301 enables a court to order repayment or restoration of money or property to the company, or the contribution of an equivalent sum, in any amount the court thinks just. This is basically the same discretion the court had under section 321 of the 55 Act. The 93 Act appears to go further, however. Paragraph 301(1)(c) empowers the court to order a director "to pay or transfer the money or property [that has been misapplied by the director or for which she or he has become liable] ... to the creditor". This is notable, not just as an extension of the 55 Act position, but rather that it seems to permit a creditor to usurp the normal order for the distribution of assets of a company upon its liquidation.[269] However, ultimately the remedy is discretionary[270] and it is submitted a court would be unlikely to grant an order which would have such effect.

Regardless of this conceptual extension from the 55 Act, the courts' treatment of its discretion granted under section 321 of the 55 Act will undoubtedly influence its approach to section 301. A survey of the case law reveals a few guiding principles but in the end the discretionary nature of the remedy means the facts of each case will determine the particular order. Bisson J in *Thompson* v *Innes* awarded only half the liquidator's claim and gave no real guidance as to how he balanced the considerations relevant to his award.[271] By contrast, in *Rex Wood* Doogue J ordered the director personally responsible for the whole sum owing to creditors upon the company's liquidation.[272] In *Electronics*, Ongley J saw fit to order the director to pay the calculated losses occurring to the company after the time it was found it should have been wound up.[273] However probably the fullest exposition of the appropriate principles the court should apply in exercising its discretion under section 320 of the 55 Act

269 See 93 Act, section 312 and Seventh Schedule to the Act.
270 The operative word in section 301 being "may". See above n 113.
271 See above Part III Section C Subsection 5 Paragraph a - *Thompson* v *Innes*.
272 See above Part III Section C Subsection 5 Paragraph b - the *Rex Wood* decision.
273 See above Part III Section C Subsection 5 Paragraph d - the *Electronics* case.

result of the breach of the section. Any funds so recovered would go towards the general assets of the company. Moreover, in line with Ongley J's comments in *Electronics* that, in the context of reckless trading the amount awarded should be limited to those losses incurred after the company should have been wound up, Eichelbaum J considered in regard to incurring obligations that the amount recoverable "should relate and be limited to those debts incurred in the absence of honest belief, on reasonable grounds, that the company would be able to pay them as they fell due".[275] Of more difficulty is whether the courts, in cases of two or more directors, are likely to impose joint and several or only several liability. In *Thompson* v *Innes* Bisson J thought the former was appropriate (but, as noted, he gave little reasoning for his decision), whilst in Vinyl Processors Hillyer J thought the directors should only be severally liable "because I do not consider that any one director should have to pay more than his share of the responsibility if any other director is unable to bear it."[276] It is submitted this discrepancy merely evidences that the court's order under section 301 will be largely driven by the facts of the particular matter.

Counsel for the directors in many of the cases under paragraphs 320(1)(a) and 320(1)(b) attempted to argue the applicability of section 468 of the 55 Act. Section 468 essentially empowered the court to grant relief in proceedings involving breach of trust against company officers. A largely analogous provision is provided by section 376 of the 93 Act.[277] The emphasis under both provisions is upon the reasonableness of the directors' actions. It is submitted new section 376 is unlikely to save directors who have breached either section 135 or 136 of the 93 Act. As breach of section 136 will necessarily require an absence of belief on reasonable grounds, then a fortiori it highly unlikely that same court would also be prepared to say the director "took all reasonable and proper steps" as section 376 requires.[278] Although section 135 makes no express reference to the reasonableness of the directors

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275 *Petherick*, above n 219, p 192; 99,960.

276 *Vinyl Processors*, above n 1, p 430; 47.

277 93 Act, subsection 376(1) provides:

> **376(1) Defences relating to board's duty** It is a defence to a director charged with an offence in relation to a duty imposed on the board of a company if the director proves that-
>
> (a) The board took all reasonable and proper steps to ensure that the requirements of this Act would be complied with; or
>
> (b) He or she took all reasonable and proper steps to ensure that the board complied with the requirements of this Act; or
>
> (c) In the circumstances he or she could not reasonably have been expected to take steps to ensure that the board complied with the requirements of this Act.

278 Such an interpretation is consistent with the comments of Hillyer J in *Vinyl Processors* where in deciding an action under paragraph 320(1)(a) of the 55 Act, he held a finbing against a director under that provision would prohibit a grant of relief under section 468 of the 55 Act. See *Vinyl Processors*, above n 1, p 440; 48.

actions, it appears the defence would similarly not be available upon the very same reasoning as Tipping J employed in *Lake Tekapo*. His Honour's comment that "in cases where a person has been found to have acted recklessly it would seem to me to be unlikely that he could also be found to have acted reasonably"[279] seems equally applicable to the 93 Act's reckless trading provision.

F Other Relevant 93 Act Provisions: The Greater Scheme Of Creditor Protection

Although companies come to an end because their purpose is spent or because those in control are in a state of deadlock, by far and away the more common reason is insolvency. Recognising this, the 93 Act makes considerable provision regarding the ascertainment and adjustment of entitlements of the relevant interest groups, be they secured creditors, unsecured creditors, employees or shareholders, upon a company's demise. In addition to the duties of directors comprised in sections 135 and 136 that clearly benefit creditors, the 93 Act contains several other provisions, though not expressed in terms of duties upon directors, that are designed to restrict the company's right to deal with its assets in the period leading up to insolvency. These include prohibitions on transactions at an undervalue,[280] transactions having a preferential effect,[281] voidable charges,[282] the general misfeasance section,[283] and a prohibition upon carrying on business fraudulently.[284] Thus directors duties are but part of a greater regulatory framework imposed on the company entity to protect its, or perhaps rather its stakeholders, interests. The effect of this regime will become more apparent in the next section.

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279 *Lake Tekapo*, above n 196, p 100,174.
280 93 Act, section 297.
281 93 Act, section 292.
282 93 Act, section 293.
283 93 Act, section 301.
284 93 Act, section 380.

IV AN ANALYSIS OF THE CONTINUED RELEVANCE OF THE COMMON LAW DUTY REGARDING CREDITORS: DOES IT ADD ANYTHING TO THE 93 ACT?

A *Introduction*

This section will attempt to analyse whether the body of case law supportive of a common law duty upon directors to consider their company's creditors' interests will, as a matter of substance, have any relevance to directors after the advent of the 93 Act. It should be noted, that such a query is not novel. It has been said of the case law:[285]

> *If these judicial utterances are examined in their context, it will be seen that in most cases they are nothing more than extraneous words of censure directed at conduct which anyway comes within some well established rule of law, such as the law imposing liability for misfeasance, the expropriation of corporate assets or fraudulent preference.*

The analysis will proceed by applying the provisions of the 93 Act, particularly sections 135 and 136 and the duties to directors contained therein where applicable, to the fact patterns of the cases comprising the body of case law supportive of the directors' duty towards creditors. As an initial observation, many of the cases comprising the case law had a number of features in common. The companies involved typically were closely controlled, being either one person companies, family companies, incorporated partnerships or group companies. Moreover, the acts in question often took place with the full knowledge of all the shareholders. Lastly, the companies were invariably insolvent at the time proceedings were brought - a liquidator being left to sue as plaintiff in the name of the company.

B *The New Zealand Cases*

1 Permakraft

The fact pattern of *Permakraft* is essentially this:

285 L S Sealy "Directors' Duties - An Unnecessary Gloss" [1988] CLJ 175, p 175.

P Ltd was a manufacturing company with subscribed capital of $25,000. Approximately 68% of the shares were held by N, 6% by his wife, 25% beneficially owned by their family trust and 1% by an employee. N, was governing director, and his wife and her brother directors. In the early 1970's P Ltd made steady profits, although by 1975 this had fallen to only $565 on sales of $520,866. P Ltd was undercapitalised and had liquidity problems. At the time there were price control regulations in place[286] which prevented P Ltd raising its prices. However, if P Ltd leased its buildings and land, instead of owning them, the rental paid thereon would constitute a justification under the regulations for a price increase. A reconstruction plan was devised which was acceptable to the secured creditors. A holding company, H Ltd, was formed to acquire nearly all the shares of P Ltd and its land and buildings at market value, as per a registered valuation, and above book value by $148,323. The capital profit to be made by P Ltd from the sale was distributed pro rata to its shareholders as a capital dividend. The dividend and the share sale proceeds enabled P Ltd's old shareholders to inject $160,000 as capital for H Ltd. The greater capital of H Ltd, relative to P Ltd, was hoped to facilitate increased borrowings. The resulting increase in P Ltd's prices was greater than the rental costs, incorporating other overheads and an increased profit margin. The scheme was implemented in July 1975. By March 1976 P Ltd was trading profitably. However, in the latter part of 1976 P Ltd encountered financial difficulties. There was evidence of industry recession, two other manufacturers in the industry went into liquidation also in this period. For the year to March 1977 P Ltd lost $135,960. Receivership and liquidation ensued.

In *Permakraft* the liquidator took an action against P Ltd's directors to recover the amount of the capital profit distributed to shareholders.[287] The Court of Appeal however, ultimately rejected the liquidator's action. Despite Cooke J's wide reaching dicta concerning directors' owing a duty to creditors,[288] it was merely that: obiter dicta. On the facts, he found the directors had acted reasonably and should not have foreseen their actions as being likely to cause loss to creditors.[289] Similarly, it would appear an action under the 93 Act for reckless trading pursuant to section 135 would not be available. If Bisson J's recklessness test from

286 Price Stabilisation Regulations 1974, see *Permakraft*, above n 59, p 245.

287 The liquidator's case was argued under three heads. First, there was no proper declaration of the dividend authorising its payment. Secondly, even if there was, the payment was not bona fide for the benefit of the company and was in breach of the director's duties. Thirdly, in either event, the company was entitled to repayment of the amount as disbursed together with interest. See *Permakraft (No. 2) Ltd (In Liquidation)* v *Nicholson & Ors* (1982) 2 NZCLC 99,758 (High Court) per White J, p 99,364.

288 See above Part II Section C Subsection 2 Paragraph a - New Zealand authority, and text accompanying above n 61.

289 See *Permakraft*, above n 59, p 253, per Cooke J:

> *The course that was in fact taken, while removing the land and buildings from the company's ownership, at least kept them within the group and helped to make further loan funds available to the group as a whole. I would not be prepared to dismiss that as an unreasonable course or as one which the directors ought to have foreseen as likely to cause loss to creditors.*

Thompson v *Innes*[290] is adopted as a proxy for "a substantial risk of serious loss to the company's creditors", it is unlikely a different result to Cooke J's would be reached. If it is asked whether there was "something in the financial position of this company which would have drawn the attention of an ordinary prudent director to the real possibility not so slight as to be negligible risk, that his continuing to carry on the business of the company ... "[291] then the answer is probably "no". P Ltd was solvent immediately after the restructuring and dividend, had greater profit margins, and had received consideration at market value for its assets (as opposed to a price obtained in a forced sale). Indeed, its profits increased in the immediate period after the transaction. Reading the Court of Appeal's decision, it is apparent other factors, such as general industry decline, probably played a larger role in P Ltd's ultimate failure.[292] In this regard the decision of *Lake Tekapo* under paragraph 320(1)(b) of the 55 Act would appear to be analogous, where Tipping J said if the company was solvent at the relevant time the director's actions in paying the capital dividend could not have been held to be reckless.[293]

Likewise, section 136 would not appear to alter the result. Although it is arguable a dividend is not an "obligation" of the company, in the strict sense, if it is assumed it is an obligation (in that, once declared, the company should pay the dividend) then on the *Permakraft* fact pattern, regardless of the director's subjective belief that the obligation (dividend) could be performed (paid), this objectively was proven to be so on the facts. The 93 Act, moreover, provides much better creditor protection than merely general duties of directors for the benefit of creditors to guard against the "mischief" of unjustifiable capital dividends[294] via section 56. Under the section, if a 93 Act company cannot satisfy the solvency test[295] immediately after a distribution[296] then the distribution may initially be recovered from the shareholder recipient,[297] and if not, the directors are personally liable for whatever part of the distribution

290 See above part III Section C Subsection 3 - Prima facie meaning of "a substantial risk of serious loss to the company's creditors."

291 Bisson J's formulation of reckless for the purposes of 55 Act, paragraph 320(i)(b).

292 *Permakraft*, above n 59, p 246.

293 *Lake Tekapo,* above n 219, p 100,172.

294 Of which, it is submitted, *Permakraft*, is not an example.

295 93 Act, subsection 4(1) provides:

> For the purposes of this Act, a company satisfies the solvency test if -
> (a) The company is able to pay its debts as they become due in the normal course of business; and
> (b) The value of the company's assets is greater than the value of its liabilities including contingent liabilities.

296 A dividend is a distribution, see 93 Act, section 53.

297 93 Act, subsection 56(1).

is not recovered from shareholders (if there were not reasonable grounds for believing the company would satisfy the solvency test at the time of the distribution).[298] In conclusion, it is submitted *Permakraft* is not a fact pattern where the directors should have been culpable for declaring the capital dividend. Prior to the restructuring the company was barely profitable and suffering liquidity problems. In such circumstances it was likely liquidation would ensue in the normal course of events. The restructuring, involving the dividend, rejuvenated the business, and the company received market value for the assets used to finance the dividend, which would have been unlikely had they been sold in a liquidation context. In this regard it appears reasonable that the 93 Act would not impose liability on the directors for breaches of sections 135 or 136. Thus, it is respectfully submitted, the Court of Appeal was correct in its decision on the facts, notwithstanding the far reaching, but obviously obiter dicta, statements of Cooke J.

2 *The* Hilton *case*

The facts of *Hilton* were akin to *Permakraft* in that they involved a company declaring a capital dividend:

> H Ltd was owned and directed by Mr & Mrs H. Declining profitability forced the Hs' cheque account into overdraft. The Hs were advised by their accountant to sell H Ltd's factory and declare a capital dividend out of the resulting profit. The factory was sold and the dividend declared. In the months leading up to the declaration H Ltd was either at or over its overdraft limit. It had received several section 218 notices, which the court construed as evidence H Ltd was unable to pay its debts as they fell due. Following the declaration it was found H Ltd was either in or very close to balance sheet insolvency.

In the case, "no express reliance was placed on any statutory provision."[299] The liquidator sought a declaration that it had acted fraudulently or negligently in declaring the dividend, and that the dividend had been declared contrary to the law. Tipping J held the dividend was unlawful as a return of capital and the credit entry in the Hs' cheque account reversed.

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298 93 Act, subsection 56(2). Non-compliance with the certification procedure for passing the solvency test is another basis for director liabilities.

299 *Hilton*, above n 68, p 64,746 per Tipping J. This appears odd as the facts would clearly appear to satisfy an action in reckless trading pursuant to paragraph 320(1)(b) 55 Act.

Similarly, the Hs were liable to compensate H Ltd in respect of their breaches of duty as directors. The duty, as enunciated by His Honour, was to ascertain H Ltd's financial position prior to declaring the dividend.[300] As they had not, the Hs were both negligent and in breach of duty.[301]

Would the Hs be similarly liable under the 93 Act? Probably yes. The real mischief in *Hilton* was that the declaration of the dividend at a time when the company was going to be unable to pay its debts as they fell due and arguably balance sheet insolvent as well. The 93 Act's provisions as to distributions[302] would prevent the directors of the company from certifying, on reasonable grounds, as to satisfaction of the solvency test after the dividend, and non-compliance would have results similar those in the case: repayment of the dividend by the director-shareholders.[303]

Whether the Hs would also have been guilty of breaches of statutory duties under the 93 Act is not so clear. Again, section 136 does not appear apt, dividends not fitting well with the notion of "obligation" central to the section. (Indeed, it is notable that if the dividend were classified as an obligation for the purposes of section 136, the company did perform its obligation - thereby satisfying the directors' duty under section 136 - notwithstanding it was insolvent in liquidity terms and arguably upon its balance sheet also!) An action for breach of duty pursuant to section 135 of the 93 Act for reckless trading would, however, appear to clearly place liability onto the directors. Under the 55 Act, merely because a company was insolvent when a dividend was declared did not make the declaration reckless for the purpose of paragraph 320(1)(b) of the 55 Act, however.[304] Even so, notwithstanding this dubious contention,[305] when a company is unable to meet its debts as they fall due and immediately after the proposed transaction will fail the balance sheet test of insolvency, on an objective

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300 *Hilton*, above n 68, p 64,751, where Tipping J notes:

> *The duty of directors [is] to take reasonable steps to ascertain the financial position of a company before declaring a dividend.*

301 *Hilton*, above n 68, p 64,754.

302 93 Act, section 56.

303 See above Part IV Section B Subsection 1 - *Permakraft*, for a discussion of the results of non-compliance with the distribution procedure established by section 56 of the 93 Act.

304 See *Lake Tekapo*, above n 196, p 100, 773, per Tipping J. It is submitted this aspect of this decision should be confined to its particular facts, as not only was payment of a dividend in circumstances of trading and balance sheet insolvency later held to be contrary to the law (see Tipping J in *Hilton*, above n 68, p 64, 750, points (4) and (5)), it would seem to go to the heart of disregarding creditors' interests at an objective level, which is surely the mischief the prohibition upon reckless trading was meant to address.

305 Above n 304.

application of section 135,[306] as the company would not be able to satisfy the 93 Act's solvency test (the 93 Act's major instrument of creditor protection) this would more than likely constitute the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors. Failing the solvency test would surely raise a "real possibility not so slight as to be a negligible risk"[307] that carrying on the business of the company would cause serious loss to the creditors of the company. Thus, it is apparent that if the facts of *Hilton* arose under the 93 Act they would most probably be decided in a similar manner.

3 The Neil *case*

Strictly, *Neil* was a case concerning an order to remove a caveat. Nevertheless, the facts of the case demonstrate director misconduct:

> N was governing director and owned all but one share in D Ltd. The day prior to the appointment of receivers in respect of D Ltd, N entered into an agreement to buy D Ltd's only asset, a property for $275,000. The property had twice been valued at $350,000. The property secured first, second and third mortgages to the sum of $150,000 and also a debenture from D Ltd securing approximately $300,000. N had placed a caveat on the property protecting his interest as purchases.

As to the issue of the caveat, Smellie J held the balance of convenience rested upon lifting the caveat (placed by N in respect of his interest as purchaser of the property) because the sale was at a clear undervalue and N's conduct was unsatisfactory.[308] Smellie J noted of the proceedings "we are once again faced with the question of whether or not a governing director, ..., contemplating the purchase of the one remaining asset of a company on the verge of receivership must take into account the interest of creditors of the company."[309] His Honour concluded the director should have or ought to have known a sale at the price obtained would prejudice the company's major creditor.

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306 It is submitted section 135 is an objective test. See above Part III Section C subsection 6 - suggested parameters of the 93 Act's section 135 duty regarding reckless trading.

307 Using Bisson J's test in *Thompson* v *Innes*, see above n 155.

308 *Neil*, above n 65, p 99,672.

309 *Neil*, above n 65, p 99,671.

Under the 93 Act on the above facts, and if the company was to go into eventual liquidation, express remedies appear provided to the liquidator under section 297 - transactions at undervalue and section 298 - transactions for inadequate or excessive consideration with directors and certain other persons. In an action under either section, the liquidator would be able to recover the amount by which the value of the company's property disposed over exceeded the consideration received by it.[310] Again, an action under section 136 seems inapplicable, and given the likelihood of recovery under either section 297 or 298, an action for reckless trading pursuant to section 135 would appear largely redundant. Nevertheless, for similar reasons to those in *Hilton*[311] it is submitted an action for breach of section 135 would probably be successful if argued.

C *The Australian Cases*

1 Walker *v* Wimborne

This case had the following fact pattern:

> R, P & D Wimborne were directors of A Ltd, one of a group of companies with common directors, authorised four payments by the company. The directors had formulated a general policy for moving funds between the companies in the group to meet emergencies as they arose. A Ltd went into liquidation. Four payments were challenged:
>
> 1. the first, to a company in the group in financial difficulty. The only consideration was the recipient company's implied promise to repay the sum. On day of payment A Ltd borrowed the equivalent amount from a third company in group - secured by an equitable charge over A Ltd's assets. A Ltd was insolvent at the time;
> 2. the second, to another company in the group for alleged consultancy work. The recipient company was not incorporated when part of work was carried out and there were no book entries to support the alleged entitlement;
> 3. third, payments as salaries/wages to employees of other companies in the group with no evidence they had performed significant services for A Ltd; and

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310 93 Act, subsections 297(2) and 298(2).

311 In *Neil* the company was about to have receivers appointed and thus clearly at least insolvent in liquidity terms. The disposal of the major asset of the company would be a major transaction pursuant to section 129 of the 93 Act, which, as distributions, require the directors to certify compliance with the solvency test. Non-compliance, it is submitted, is clear evidence of reckless trading for section 135.

4. fourth, to a former director of A Ltd in recognition of past services. A decision to make these gratuitous payments by way of regular pension was made well before winding up became imminent.

The four payments were challenged by the liquidator as having been made in breach of duty or trust under New South Wales' misfeasance provision.[312] The court held the directors liable for payments one, two and three. Under the 93 Act, with regard to the first payment, would probably be impugned by both sections 135 and 136. At least, taking on the additional borrowing, whilst being insolvent and knowing the company's capacity to repay depended upon another company known to be in financial difficulties being able to repay its debt, would not appear to be grounds on which a belief that the company could perform its obligation when called upon to do so, be objectively held (for the purposes of section 136). Regarding the second payment, Mason J in the case found that there was clear misfeasance as it was a serious breach of duty to make a payment on a basis that proved to be without foundation.[313] Strictly, the duties in section 135 or 136 would not appear breached by the conduct. However, the duty to act in the best interests of the company[314] would clearly appear breached, and give rise to an action under section 301. Similar analysis can be applied to the third payment.

2 Ring *v* Sutton

The facts of *Ring v Sutton* are these:

> S and his wife were directors of N Limited. They were also the only shareholders of N Limited. S had received a number of loans from N Limited over several years prior to N Limited's eventual winding up. The rates of interest upon these loans were less than the rate of bank interest charged at the relevant time of the loans. S profited as a result of the transactions by the difference between the interest rate which should have been paid under contracts entered into with a bank and the interest payable under the contracts he procured as director.

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312 Companies Act 1961 (NSW), section 367B.
313 *Walker* v *Wimborne*, above n 37, p 10.
314 93 Act, section 131.

The liquidator brought an action against the director for damages for misfeasance. Giving the court's judgment, Hope J A declared the director had been guilty of breaches of duty as an officer of the company by causing it to lend to him sums of money over a period of years at interest rates lower than commercial rates. His Honour, drew the inference that the director obtained more favourable treatment because of his position as a director. None of the three loans were for the benefit of the company and the terms, as to interest, were detrimental to the company.[315]

It would not appear that either section 136 nor section 135 of the 93 Act are applicable. Certainly, in making the loans, the company did not incur what could be said to be an obligation to make section 136 applicable. Likewise, it is unlikely that the director, in authorising the loans to himself at a below market interest rate, could be said to be trading recklessly for the purposes of section 135. At the time the loans were made, there was nothing in the financial position of the company that could really be construed as a real risk that serious loss to creditors would occur. On the facts, the amount of interest lost through the loans was approximately just over $30,000, whilst upon the company's winding up it had accumulated losses of approximately $280,000 and a deficiency of liabilities over assets of $265,000.[316] It is submitted, however, that the director would have been in breach of section 131 of the 93 Act which obliges directors to act in good faith and in the best interests of the company.[317] Although the courts have been reluctant to second guess directors decisions, it is submitted that the effect of section 137 of the 93 Act is to be impose an objective element to the interpretation of the section 131 "best interests of the company" duty. As the company received no material benefit from the loans, objectively, it would be hard to justify that they were in the best interests of the company.[318] Thus, again, although strictly the directors actions in the fact pattern may not be actionable under section 135 or 136 of the 93 Act, the 93 Act elsewhere provides a suitable remedy against the director misconduct elsewhere.

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315 *Ring* v *Sutton*, above n 41, p 550.

316 *Ring* v *Sutton*, above n 41, pp 546 & 550.

317 93 Act, subsection 131(1) provides:

> subject to this section, a director of the company, when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company.

318 Depending on whether at the time of making the loans, the director disclosed his interests in the transactions (assuming the company is a 93 Act company) in the interest register, the loans could be avoided by the company at any time up to three months after the transaction was eventually disclosed to its shareholders. See generally 93 Act, sections 140 & 141.

3 *The* Kinsela *case*

The facts of *Kinsela* were as follows:

> R Ltd was directed by Mr and Mrs K. Mr K owned all of the governing director shares and the ordinary shares were held between Mr and Mrs K and other members of the K family. In January 1981 R Ltd entered into a lease of its business premises to the K's. On the facts, the court found R Ltd's financial position was "precarious". Earlier R Ltd's liabilities exceeded its assets by approximately $195,000. The rental payable on the lease was substantially below market rentals. In April 1981 R Ltd was ordered to be wound up as an insolvent company. The effect of the lease was to put R Ltd's asset (its business premises) beyond the immediate reach of its creditors. The shareholders of R Ltd had unanimously approved R Ltd entering into the lease.

In the case, Street CJ held that the entry into the lease by the directors was "in breach of their duty to the company in that it directly prejudiced the creditors of the company. It was accordingly a voidable transaction."[319] With regard to the application of the 93 Act, it should first be noted that the lease would not be a voidable preference pursuant to section 292, as the directors were not creditors of the company. Arguably, the lease may constitute a transaction at an undervalue,[320] or a transaction for inadequate or excessive consideration with directors.[321] It is submitted, however, that the directors would probably be liable for reckless trading under section 135. The facts raise the issue whether section 135 covers isolated transactions.[322] As opposed to paragraph 320(1)(b) of the 55 Act, which referred to "any business of the company, and which the Court of Appeal held could include an isolated transaction - even a transaction not arising in the course of carrying on the company's usual business[323] section 135 refers to carrying on "the" business of the company". It is submitted, the courts would take a similarly broad interpretation of section 135, as they did with

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319 *Kinsela*, above n 45, p 224.

320 93 Act, section 297. The lease would certainly be entered into within the specified period (which is one year prior to liquidation, subsection 297(3)), it was entered into when the company was unable to pay its debts, subparagraph 297(1)(c)(i), and the directors ought to have known that this was the case, required by paragraph 297(1)(d), and, most improtantly, the value of the consideration received by the company, i.e., the rental, was less than the value of the consideration provided by the company, i.e., the value of the business premises. If the foregoing was proven, a liquidator could recover from the directors the value of the excess consideration provided by the company.

321 93 Act, section 298. The issue in this instance, will be whether the company disposed of property by leasing it to the directors (see subsection 298(2)). Again, if proven, the liquidator could recover from the directors the value of the excess consideration provided by the company.

322 For further discussion, see above Part III Section C Subsection 6 - Suggested parameters of the 93 Act's section 135 duty regarding reckless trading.

323 See *Nimbus*, above n 171,

paragraph 320(1)(b) of the 55 Act, given the remedial nature of the provision. Moreover, if the aim of the section is to prevent losses to creditors, a restrictive interpretation to only the "core" business of the company would severely limit the section's effectiveness. A fortiori, where a company has disposed of its major asset, as it had on the facts of *Kinsela*, immediately prior to liquidation, it dramatically illustrates how a substantial loss can be inflicted upon creditors. On the facts of the case, the directors must have known removal from the company of its major asset, given its impending collapse, would "create a substantial risk of serious loss to the company's creditors." Once again, the present statute based law on directors' duties would appear to censure the director misconduct in another of the cases evidencing judicial sympathy for a common law duty of directors to creditors.

4 Grove *v* Flavel

Grove v *Flavel* was a case where the director of the impugned company was also a director of several related companies. The facts were:

> G was a director of B Ltd, as well as a director of five project companies and two family companies. Prior to February 1981 G and one of the family companies, M Ltd, were unsecured creditors of B Ltd. The project companies were all indebted to B Ltd, and had considerable assets in the form of real property. By virtue of his position as a director of B Ltd, G knew B Ltd was experiencing liquidity problems. He was also aware its bank had refused B Ltd a loan. In February 1981, B Ltd repaid a large portion of the amount it owed G, as well as all it owed to M Ltd. G then drew a cheque in favour of the other family company, which in turned drew a cheque in favour of B Ltd. M Ltd drew cheques in favour of B Ltd repaying all the debts owed to B Ltd by the project companies. The net effect of the transactions did not affect B Ltd's liquidity. However B Ltd's indebtedness to G was reduced, and the project companies become debtors of M Ltd and not B Ltd.

The immediate remedy under the 93 Act would be pursuant to section 292, attacking the payments by the company to its director and the other company as voidable preferences. The payments would most likely be voidable if the company went into liquidation within six months of their making.[324] If it could be shown that the payments were in the ordinary course

[324] This is because the 93 Act, subsection 292(3) presumes transactions made within the restricted period (6 months prior to liqudiation) to be made when the company was unable to pay its debts and otherwise than in the ordinary course of business, unless the contrary can be proved.

of business for the company, or liquidation was delayed until after six months from when the payments were made, then there is less chance of a liquidator avoiding the payments. In this scenario, however, an action against the director for reckless trading may also be available. If it is shown the payments were in the ordinary course of business then clearly "the business of the company" element of section 135 would appear to be satisfied. Furthermore, the facts would appear to create clear prejudice, and hence risk of loss, to the company's creditors. The payments had the effect of diminishing the assets available for the benefit of creditors upon the company's insolvency. The debts due to the company from the project companies would otherwise have been available for creditors in general upon the company's liquidation.

D *The English Cases*

1 *The* Winkworth *decision*

Winkworth was a case concerning:

> Mr and Mrs W purchased the 2 issued shares of E Ltd, using money from E Ltd's bank account, and in doing so became E Ltd's only directors. E Ltd then purchased a freehold property which the W's occupied as their home. E Ltd's bank account was overdrawn as a result. On Mr W's instructions E Ltd's solicitors gave an undertaking to the Bank to hold the deed of the property to the order of the Bank. Mr W incurred considerable personal expenditure on E Ltd's account. Some months later E Ltd mortgaged the property to a third party with Mrs W's signature being forged on the documents by Mr W to pay debts incurred by Mr W. The company became insolvent and went into liquidation. When it defaulted in paying the mortgage, the third party brought an action for possession. Lord Templeman held Mr W had acted in breach of the duty he owed as a director to the company and its creditors to ensure that the affairs of the company would be properly administered.[325] Clearly, this would be a breach of section 131 of the 93 Act.

325 *Winkworth*, above n 83, p 116.

2 *The* West Mercia *case*

West Mercia had the following facts:

> D was a director of W Ltd. W Ltd was a wholly owned subsidiary of A Ltd, of which D was also a director. Both companies were in financial difficulty and insolvent. A Ltd had a substantial overdraft secured by D's guarantee and a charge on its book debts (which included a debt of about £30,000 owed by W Ltd). An accountant was called in to liquidate the companies and he informed the directors that the companies' bank accounts were no longer to be operated. Prior, D had instructed the bank to transfer £4,000, just paid to W Ltd's account by a debtor, to the overdrawn account of A Ltd. There was no obligation on W Ltd to do so. D's sole purpose in doing so was to relieve his personal liability under his guarantee. On the facts Dillon LJ said "to my mind it is quite clear that there was a fraudulent preference."[326] It is submitted the transfer would clearly be recoverable by a liquidator as a transaction at an undervalue.

E *Comments As To The Relevance Of The Common Law Duty*

The fact patterns of the cases espousing a common law duty upon directors to consider the interests of their companies creditors do not uniformly give rise to breaches of sections 135 and 136 of the 93 Act. However, it is submitted that, although director liability may not be imposed invariably under those provisions, the mischief of the directors in the cases would usually be impugned by some aspect of the greater regime of creditor protection provided in the Act.[327] In *Hilton*, the directors would be liable for reckless trading in breach of section 135; in *Neil*, primarily actions could be taken under section 297 or 298,[328] but also possibly in reckless trading if it was so desired; *Ring* v *Sutton*'s facts would not appear to afford breaches of either section 135 or 136, but most likely a liquidator would have an action for breach of the duty to act in the best interests of the company;[329] in *Kinsela*, it is also likely the directors traded recklessly, but again, primarily, initial causes of action would be under sections 297 or 298;[330] and on *Grove* v *Flavel*'s facts an action would appear to lie in voidable preference.

326 *West Mercia*, above n 86, p 32.
327 A notable exception is the *Permakraft* case, which it is submitted is a case where the so called director 'mischief' was not, as the court found, deserving of censure on the facts.
328 Transactions at an undervalue, or for inadequate or excessive consideration with directors, respectively.
329 93 Act, section 131.
330 Above n 328.

Thus, it appears as the law stands, it gives ample scope presently to deal with all the potential abuses of trust or mischief (as this paper has referred to the notion) by company directors. There appears little need for continued judicial expression of the plight of creditors and an amorphous conception of a duty owed by directors to them, outside of the context of the statutory regime provided by the 93 Act. It is submitted, the advent of the 93 Act has and should signal the demise of judicial sentiment, that although understandable, was largely redundant and conceptually unsustainable[331] in its more extreme forms. In Sealy's words there seems no longer any "need to invent any new cause of action based on phoney jurisprudential antecedents."[332]

[331] See the problems of owing a duty to competing interests discussed above Part II Section D Subsection 1 - To whom is the duty owed? to the company or to creditors and Part II Section D Subsection 3 - The extent and content of the duty.

[332] Sealy-Cambridge, above n 8, p 177.

V DO CREDITORS NEED PROTECTION? PLACING DIRECTORS' DUTIES TO CREDITORS IN THE CONTEXT OF THE STAKEHOLDERS DEBATE

A Introduction: Corporate Failure And The Focus Of Judicial Sympathies

The body of case law this paper focuses upon has been seen to take as its starting point the principle that creditors are, in some circumstances, deserving of protection.[333] Both prior and after the share market crash, the collapse of large numbers of corporations and magnitude of their unpaid debts obviously raised speculation as to whether directors should bear more responsibility for the enormous costs of such failure, both to creditors and society generally. In such an environment the problem has been perceived to rest squarely with directors and the law has responded via increasing their obligations in favour of creditors as though it was the natural remedy. It has been said that this "indicates a naive approach"[334] and has "been adopted without any critical assessment of the role of the corporate creditor or the harm the status quo may hold for them".[335] Moreover, in light of the continuing debate in the United States, it cannot be said that the principle is self evident. There, the debate is divided between those who view the market as providing all necessary protection and those who perceive the existing forms of protection available to creditors to be only partially effective.

B Preliminary Viewpoints As To The Need For Creditor Protection

1 Proponents that the market is adequate protection

Proponents of the notion that the market will adequately protect creditors do so from an analysis premised on risk and who bears it. The likes of Posner[336] and Easterbrook and Fischel[337] approach the issue by noting that the interest rate charged on any advances to a company is payment in advance, not only for the rental of capital, but also for the risk that the

333 See above Part II section 3 - the Courts' Extension Of Directors' Duties To Include Creditors.

334 M Byrne "An Economic Analysis Of Directors' Duties In Favour Of Creditors" (1994) 4 Aust J Corp L 275 ("Byrne"), p 275.

335 Grantham, above n 34, p 1.

336 R A Posner "The Rights of Creditors of Affiliated Corporations" (1976) 42 U Chic LR 499 ("Posner 1976") and *Economic Analysis of Law*, 4th ed, Little, Brown & Co, Boston, 1992, Chpt 14.

337 F H Easterbrook and D R Fischel "Limited Liability And The Corporation" 53 U Chic LR 89 ("Easterbrook & Fischel").

borrower company will not repay the advances. Increases in risk are therefore matched by increases in interest rates, so that the creditor is theoretically relatively non-plussed about the actual outcome of the venture.[338] Further, because of the relationship between risk and interest, it is actually the company borrower that bears the risk of the advance. So an increase in interest rate occasioned by, either, the company undertaking a risky venture or its general lack of credibility, reduces the value of the company to its shareholders (owners) and thus there exists incentive for the borrower to adopt low variance projects and conduct that otherwise inspires confidence.[339] The market supporters therefore conclude that, absent misrepresentation by the borrower company of facts relevant to risk assessment, company creditors will be adequately protected.[340] Such reliance on shareholder constraint of director conduct appears misplaced if reference is made to the cases in which director misconduct has arisen. For example, the cases evidencing the common law duty to consider creditors' interests invariably involve closely controlled companies where there is often perfect correlation between the directors and shareholders.[341] In such circumstances, shareholder restraint of director conduct is illusory.

2 *The shortcomings of market restraints*

Against this idealised view of a perfect market in which all participants have complete information and are fully compensated for the level of risk they choose to bear, are some cogent criticisms of the market's ability to provide adequate protection. The critics assert there will be situations where the interest rate provided does not accurately reflect the level of risk undertaken so enabling the company to externalise[342] the cost of the borrowing. There are two grounds for their criticism.

The first is that the market can only accurately assess the interest rate where full information is available about the nature of the investment, the borrower company's ability to reach

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338 Posner 1976, above n 336, p 501.

339 Posner 1976, above n 336, p 509; Easterbrook & Fischel, above n 337, p 105.

340 Posner 1976, above n 336, p 521.

341 See *Permakraft*, above n 59; *Hilton*, above n 68; *Neil*, above n 65; *Ring* v *Sutton* 41, above n; *Kinsela*, above n 45; and *Winkworth*, above n 83, for example.

342 "Externality" has been defined as:

> *A side effect or consequences (of an industrial or commercial activity) which affects other parties without this being reflected in the cost or price of the goods or services involved.*

See *The New Shorter Oxford Dictionary* M Lindsay (ed), Clarendon Press, Oxford, 1993.

completion and the company's general financial position. Thus, in the absence of full information, it follows that the interest rate will not always be capable of reflecting the actual risk. It should be noted the efficient markets hypothesis[343] which, if true, supports an argument of accurate pricing, is coming under increasing criticism both as to its empirical claims and theoretical basis. The second criticism is that the rate of interest charged to the company only reflects the risk perceived by the creditor at the time the loan was made. Unforeseen changes (increases) in that risk effectively lowers the rate of interest, which transfers the cost of the debt to the creditor.[344]

In response, Posner et al suggest that informational deficiencies which result in inadequate interest rates can be rectified by contract. Covenants which preserve the debt equity ratio upon which the interest rate is determined can be included in loan documentation. In reply, the critics of market restraints refer to empirical evidence which suggests the use of such covenants, at least amongst lenders in the United States, is not widespread.[345] Moreover, such covenants are inappropriate for trade creditors, being the type of creditor least equipped to assess risk and therefore in most need of protection.[346] Indeed, thus far, the preliminary viewpoints of each have been in the context of solvent entities. The onset of insolvency changes this analysis. Specifically, with reference to the reckless trading offence, in particular, it will be the trade creditors who are most prejudiced by the company continuing to trade on once it should have been liquidated.[347]

C *Limited Liability Of The Company: The Crux Of Creditors' Problems*

In identifying the extent of the problem of company failure for creditors the fundamental issue is the limited liability of the company. Although the advantages of limited liability are generally premised on the economic benefit that accrues from being able to mobilise

343 The efficient markets hypothesis, or EMH, postulates (in its semi-strong) form that all relevant information will be available to the market and that the market will rapidly, if not instantaneously, digest all information as it becomes available.

344 J M Landers "Another Word On Parents, Subsidiaries and Affiliates In Bankruptcy" (1978) 43 U Chic L R 527 ("Landers"), pp 530 & 531

345 Grantham, above n 34, p 3, fn 12.

346 Landers, above n 344, pp 530 and 540.

347 See above Part III Section 5 - Application by the courts of the reckless trading offence: the leading cases under paragraph 320(1)(b).

diversified groups of capital contributors without endangering their reserved resources,[348] the nature of limited liability companies causes the risk of the ventures to be borne predominantly by the creditors.[349] Sealy has noted, however:[350]

> *"that for all the prominence given in the books to the phenomenon of 'lifting the veil', the one unassailable concept in our company law appears to be that of limited liability...Statutory exceptions apart, Salomon [351] rules. Limited liability is sacrosanct."*

But the distribution of risk itself is not perceived as the problem. Rather, it is only when creditors are bearing risks for which they are not compensated in some way (e.g., increased interest rates or additional security) that creditors suffer.[352] As such, the limited liability of companies at law simply effects the initial allocation of risk. For advocates of market restraint, the rules of law have little impact on the final allocation of risk, as parties will contract around the legal regime to maximise their utility provided the costs of doing so do not exceed the benefits.[353] However, trade creditors, unlike secured creditors, are typically going to be supplying on standard terms and conditions determined by market practice. Indeed trade creditor initiatives to protect themselves from company insolvency risk, i.e., *Romalpa* clauses, have only been of limited effect in displacing the allocation of risk established at law by the likes of the 93 Act, for example.

As such, the reality is of course that the market is not perfect. This is most emphasised where the company borrower approaches insolvency. In this situation the self interest argument, that riskier undertakings increase borrowing costs (interest rates) for the company and reduce the company's value to its owners, the shareholders, is premised upon a continuation of company business, and so to that extent is inapplicable. So with pending insolvency, and no long term horizon for directors to consider, it is rational for the company to undertake riskier projects in the hope, albeit remote that the potentially large returns will stave off insolvency. Limited

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348 See H A J Ford & R P Austin *Ford's Principles of Corporation Law*, 6th ed, Butterworths, Sydney, 1992 ("Ford"), p 84, para 408; P Halpern, M Trebilcock and S Turnball "An Economic Analysis of Limited Liability In Corporation Law" (1980) 30 U Tor LJ 117 ("Halpern, Trebilcock & Turnball"), p 125.

349 Landers, above n 344, p 529.

350 L S Sealy "Directors Wider Responsibilities" (1987) 13 Monash ULR 165, p 180.

351 *Salomon* v *Salomon & Co* [1887] AC 22, where it was confirmed that registration of a company would enable the sole trader to obtain the benefits of limited liability.

352 Byrne, above n 334, p 276.

353 See R H Coase "The Problem of Social Cost" (1960) 3 J of Law & Econ 1 ("Coase"), p 18 cited in Byrne, above n 334 , p 276, fn 5.

liability is the basis of such a decision. Upon insolvency the shareholders' investment is already lost and there are no additional risks to shareholders from using what is essentially the creditors' money in a last ditch rescue bid. Thus, the onset of insolvency has the effect of altering the company's motives and there are relative gains for externalising the cost of borrowing to create uncompensated risks for the creditor. There are basically two ways in which this harm to creditors may be occasioned.

D *Problems Faced By Creditors: Decreasing Assets And Increasing Liabilities*

Though the circumstances whereby directors' conduct may harm creditors can be conveniently divided into two categories, they are, as Grantham notes, merely different facets of the same problem.[354] The first is by reducing the company's assets. For example, the assets from which the creditor can be repaid may be dissipated by sales at undervalues, dividends, or the granting of security over them. It has long been recognised by legislatures throughout the Commonwealth and in the United States as well[355] that this facet is undesirable.[356]

The second situation is where the company debtor continues to incur liabilities after the initial advance from the creditor. Like diminishing the company's assets, this similarly increases the company's debt equity ratio, in turn raising the risk associated with the company and lowering the value of the interest rate paid to the creditor. Some commentators have noted that this second situation has been largely ignored by the law to date.[357] For example, McPherson concluded:[358]

> *It is profligate use of corporate power to incur liabilities that presents both courts and legislatures with the most pressing contemporary problem in company law.*

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354 Grantham, above n 34, p 3; cf B M McPherson "Duties of Directors to Shareholders and Creditors" in Legal Research Foundation *Company and Securities Law After The Market Crash*, Legal Research Foundation Inc, Auckland, 1989 ("McPherson"), pp 8-18.

355 See R C Clarke "The Duties Of The Corporate Debtor To Its Creditors" (1976) 90 Harv LR 505. See also above Part III Section F - Other Relevant 93 Act Provisions: The Greater Scheme of Creditor Protection, for provisions of the 93 Act prohibiting such dissipation of assets.

356 For example, in New Zealand the 93 Act proscribes transactions at undervalue - section 297, voidable charges - section 293 and regulates dividends - sections 53 & 52.

357 See Grantham, above n 34, p 4.

358 McPherson, above n 354, p 14.

And he continued to proclaim:[359]

> *It would require bold interpretation of the underlying thesis of companies legislation for a court to condemn as legally improper the exercise of corporate power to accumulate liabilities once it was evident that the company could never succeed in discharging them.*

By contrast, Grantham has suggested that creditor protection will only be warranted, first when it is effective immediately before and during insolvency, and secondly, if, in that period, the company's ability to incur additional liabilities is restricted. The respective commentators musings may well be contradicted and met respectively, by the duties comprised in sections 135 and 136 of the 93 Act. Verily, section 136 prohibits directors from agreeing to the company incurring obligations unless the directors could objectively believe the company will be able to perform those obligations. Moreover, it is apparent McPherson's "bold interpretation of the underlying thesis of companies legislation" seems to have been with us for some time, if reference is made to paragraph 320(1)(a) of the 55 Act, for example. The 93 Act appears to specifically address both commentators concerns.

E The Role Of Directors And The Costs Of Increasing Liability

The role and duties of directors needs to be, and should be, analysed within a wider risk sharing context.[360] Although it is easy enough to identify the concerns of creditors, it is another thing to advocate that increased directors' responsibilities are necessarily the appropriate corrective measure. If it is shown that directors are responsible for the concerns of creditors, it would be logical to restrain the actions of directors to prevent that harm. However, the costs of such restraint should also be considered prior to its imposition. As noted, the duties upon directors in favour of creditors describe the initial allocation of risk imposed by law.[361] What is important, according to advocates of market restraint such as Posner, is how that initial allocation of risk is dealt with by the parties in their bargains. The parties must be able to properly factor in those duties in reaching an acceptable final risk sharing arrangement. Unless the initial allocation of risk reflects the optimal position for the

359 McPherson, above n 354, p 14.
360 See above Part III Section F - Other Relevant 93 Act Provisions: The Greater Scheme of Creditor Protection.
361 Coase, above n 353, p 3.

parties, there will be costs involved in doing so. Thus, the issue becomes the ability of the parties to properly contract around ever increasing directors' duties and the associated costs of so contracting.[362] It is, however, appropriate to first examine whether directors are the sole cause of creditors' problems.

1 *The question of causation*

Prior to determining how director conduct should be restrained, it should first be demonstrated that directors are responsible for the creditor concerns outlined above.[363] If directors derive no utility from the costs incurred upon creditors, it is not rational that they act to cause them. It is, however, submitted that directors, in certain circumstances, will have the necessary incentives to cause creditors to undervalue their risk. Factors relevant to directors' incentives would be the size of company being managed, the directors' interest in the company and the form of directors' remuneration or compensation.[364] For example, in closely held companies where directors are also shareholders, there is considerable incentive to increase the creditors' risk. This is certainly the effect evident from the cases in which the judiciary have supported a common law duty. In the context of closely held companies, contract arguably provides an effective means by which creditors could avoid these competing incentives, however, via creditors, for example, insisting on personal guarantees from the directors of the company. This has the effect of aligning creditors' concerns with the directors' interests. But director guarantees can also be a double edged sword. For example, in *Winkworth*, a personal guarantee of another company in the group was the incentive for breach of the director's duty. For directors of large public companies, if it is assumed that such directors' utility is maximised directly in proportion to the success of the company (which will be dependent on the compensation package of the director) the personal benefit to the director will be strongly linked to the performance of the company. Conduct likely to result in the failure of the company is said to not appear to further the directors' own interests.[365] Thus, directors' attitudes in publicly listed companies appear governed largely by the way they are

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362 Byrne, above n 334, p 279.
363 See above Part V Section D - Problems Faced by Creditors: Decreasing Assets and Increasing Liabilities.
364 Byrne, above n 334, p 279.
365 It may well be that the shareholders of such a company may feel aggrieved by inappropriate risk aversion from the directors. Shareholders, unlike creditors, may vent their dissatisfaction by voting the director out at general meeting, however.

compensated. Disproportionately large bonuses or other rewards may serve to align directors' interest with shareholders' interests, which may have the effect of increasing directors' propensity to adopt risk, to the detriment of creditors. If directors are being compensated to carry out risky ventures for the benefit of shareholders, it may be equally appropriate to require such directors to bear responsibility for this behaviour. It is, however, difficult to assess the validity of the argument because, as noted, the preponderance of the cases where directors' obligations to creditors have been at issue have involved closely held companies.

2 *Are current attempts to restrain directors the appropriate corrective measures?*

If it is assumed directors have a role in causing the problems faced by creditors, what is the appropriate method by which directors can be restrained? As we have seen, the response of the common law, and latterly of the legislature, has been to impose directors' duties which increase the responsibilities of directors, to the benefit of creditors.

With regard to the common law duty, perhaps the most striking element of its approach is the obsession with the insolvency of the company. This focus is premised on the belief that at the point of insolvency the assets of the company should be available for the exclusive benefit of creditors. It has been said this "oversimplifies the analysis and overstates the significance of insolvency".[366] Insolvency is, rather, the time when the loss manifests itself. If it is accepted that creditors suffer only when they have been caused to accept risks for which they have not been fully compensated, the attention should only be on uncompensated risks.[367] As such, this problem exists whether the company is solvent or not. Substantively, the only difference between solvency and insolvency is that, in one instance, the increased risks imposed upon creditors by directors in undertaking higher risk ventures on behalf of the company, if they are proved fruitful, the directors are *not* perceived to have acted improperly, whereas if those same high risk ventures fail, and the company becomes insolvent, the directors' initial decision is analysed as being potentially in *breach* of their duty. Byrne argues, therefore, that it is inappropriate for the common law duty to focus upon insolvency, as it is inequitable to impose the duty on grounds not connected with conduct.[368] The law,

366 Byrne, above n 334, p 280. Byrne submits the insolvency is not the cause of the loss.
367 See Coase, above n 353.
368 Byrne, above n 334, p 280.

however, has always differentiated between conduct and its consequences. The criminal law distinction between full offences and mere attempts is the best example. Although theoretically unexpected director risk adoption that begets success on the one hand, but also failure on the other, is equally blameworthy. However, in one scenario, the creditors bear no tangible loss beyond the 'additional uncompensated risk' they bear with is, arguably no detriment at all.

The importance of solvency of the company is said to be, rather, that it highlights the last act of obtaining credit which pushes the company into insolvency.[369] A duty upon directors may therefore be of benefit to creditors if it provides directors with an incentive to more closely monitor the financial state of the company. Certainly, this would appear to be the substantive effect of the 93 Act's section 135 and 136 provisions.[370] However, there remains no link with the most crucial factor of the analysis, which is the risk a creditor was prepared to accept. If a creditor, for example, has recognised the full risk and contracted on the basis that the company may technically be fluctuating in and out of solvency, it is arguable that creditor should not be entitled to other remedies. The creditor has made a fully informed decision on the risks known to it. A duty owed by directors to creditors thus conceivably provides creditors with a remedy to which they should not be entitled. It is, in a sense, a "second chance" for the creditor. Moreover, if it is acknowledged that director liability may eventuate whether or not the creditor negligently or naively failed to undertake proper inquiry (as would be expected of the "average" creditor), this proposition is more alarming. However, in practice, it is submitted there are unlikely to be many creditors willing to advance funds knowing the borrower is fluctuating in and out of solvency. This paper has highlighted the responsibility of directors to avail themselves of the true position of the company and its financial solvency. By contrast little commentary has been devoted to the ability of creditors to take appropriate steps in appraising their risks and protect themselves.

369 Byrne, above n 334, p 280.
370 See above Part III - The Companies Act 1993 And Statutory Based Directors' Duties For The Benefit Of Creditors.

3 *The total cost of increasing directors' duties*

a *increased compensation and insurance and indemnities*

The foregoing analysis is premised upon the basis that the imposition of liability upon directors will provide the necessary incentive for them to comply with the desired behaviour. It has been suggested that there are some significant flaws in such an approach.[371] The consequence of the imposition of increased directors' duties is that directors bear increased risks and obligations. Yet, directors are said to be extremely poor risk bearers.[372] Directors' personal liability is unlimited. Moreover, if they are in the service of a single company, they are unable to diversify their investment and spread their risks. The result would be that directors would need increased compensation for their increased risks, and such compensation would probably be relatively high, given directors inability to avoid the potential liability or reduce its impact. An alternative is for shareholders to indemnify directors for their liability.[373] Insurers and shareholders, being good risk bearers, [374] are said to be able to assume this role much more cheaply. Thus, shareholders will prefer to provide an indemnity or pay insurance rather than compensate directors directly. This could be viewed as internalising the cost of the directors' risk in an equitable manner.[375]

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371 See Byrne, above n 334.

372 R H Kraakman "Corporate Liability Strategies and the Costs of Legal Controls" (1984) 93 Yale L J 857.

373 See the 93 Act, section 162. Indemnification, however, is only available for director liability to any person other than the company, subsection 162(4), and, at least in respect of the statutory duties imposed by sections 135 and 136 of the 93 Act, these are duties owed to the company. Indemnification would arguably, however, be available for liability pursuant to section 301 to a creditor in an action against a director for misfeasance in respect of a breach of sections 135 or 136 of the 1993 Act.

374 See Kraakman, above n 372.

375 The risk has appeared to move the full circle. Creditors initially bear extra risk due to the limited liability of the company. In a perfect market, creditors would be fully compensated for their risk. However, in the real world, high transaction costs and incentives within the company structure for directors to engage in riskier ventures, mean creditors may be viewed as suffering under a bias. The bias favours the shareholder given the potential for higher returns. This is even more likely to occur where the directors' interests are aligned to those of the shareholders, via fear of removal or share value related compensation packages. To allow directors to be liable to creditors for creditor loss but to transfer the cost of such liability to the shareholders by way of indemnity or insurance (which would be paid directly by the company or indirectly via increased salaries) is to make the shareholders pay for the original benefit. Thus the circle is complete. See Byrne, above n 334, p 283. The foregoing analysis is, however, premised on perfect transfers of risk. It is unlikely there could ever be a total shift of risk by indemnities or insurance and the extent to which this cannot occur will be reflected in more costly corporate governance.

b *making directors risk averse: fettering risk taking*

Beyond the increased cost of insurance or indemnities, it may be argued that the more serious cost of increasing directors' duties to creditors is upon the performance of the directors. Increased liability will beget increased incentive to avoid higher risk ventures and their associated greater chance of financial failure. Such a cost, it is submitted, threatens the basis of capitalist enterprise, notwithstanding the problems there would be in quantifying such a cost.[376] For example, Sealy has warned:[377]

> *Any reformulation of directors' duties to take account of the interests of creditors and others has to accommodate the concept of risk, and allow for the fact that directors must be free to take risks and to judge what risks their business should take.* ***We must not loose sight of the fact that it is the principal function of the limitation liability company, and of company law, to facilitate this risk taking;*** *without it, the world's railways would not have been built and we would have had no industrial revolution, no modern technology. It is impossible to reconcile a duty of care towards creditors with this notion of risk.* [378]

F *Final Policy Comments*

Byrne has suggested that the limited liability structure results in a slight bias against creditors, as they are prejudiced only when they take on risk which cannot be incorporated into the credit contract at the time it is created. It is argued the bias is slight, because there are means available to the creditor to overcome this initial allocation of risk.[379] However, the propensity of certain types of creditors, most particularly trade creditors, to contract around this bias must be questioned. Moreover, contractual solutions can be just as problematic where group company situations are involved, as, for example, contractual risk adjustment in

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376 Quantification of the cost would be relevant if it is to be balanced against the benefits afforded to creditors by the imposition if increased duties.

377 Sealy-Monash, above n 91, p 181 (emphasis added).

378 It is on such grounds that a "business judgment rule" has appeal. Such a rule allows a director to be able to defend what might otherwise be considered risky decisions given the particular circumstances of the occasion. Director conduct may be defended on the basis of the circumstances that existed at the time of their decision. In the United States, the American business judgment rule protects all decisions from being in breach of duty unless they may be considered to have reached a level comparable to gross negligence.

379 For example, in the context of closely helped companies, personal guarantees help to realign creditor and director interests.

one case by way of a personal guarantee of one group company provided director incentive for misconduct in relation to another.[380]

Byrne has also suggested that the attempts to redress the problems faced by creditors should focus on the directors' role in allowing creditors to assume uncompensated risks.[381] The common law duty and the courts' interpretations of the statutory duties, with their focus upon the solvency of the company although said to assist creditors to identify subsequent risk, is aimed at the fact that creditors' advances may not be repaid, rather than creditors being insufficiently compensated for their risks to begin with. Moreover, it is apparent directors can still be rewarded for misleading creditors when their risky ventures are successful. With respect, however, directors are rewarded for misleading creditors whether the venture succeeds or fails, because in both situations they obtain creditor financing at a discounted rate to that which would reflet the company's "true" risk. Creditors must ultimately be concerned with being repaid, and the law's, and especially the duties provided by sections 135 and 136 of the 93 Act, are it is submitted a pragmatic and appropriate approach.

380 See *Winkworth*, above n 83.
381 See Byrne, above n 334.

VI FINAL COMMENTS

A The Common Law Duty Regarding Creditors:

The cases surveyed[382] in this paper illustrate there was a considerable amount of judicial sympathy amongst New Zealand, Australian and English courts to the notion that directors of companies owe a duty to consider the interests of their companies' creditors, at least when the company is insolvent. The concept, however, is at best nebulous. The various commentary from the bench, proffered by legal academics as formulating the duty, are upon examination, only obiter dicta. The cases provide no instance where the concept has been fundamental to imposing liability upon directors. As would be expected of such a situation, it is extremely difficult to tie down what conduct the duty would prescribe. More problematic, are some of the conceptual difficulties. If directors owe a duty to creditors, or rather to consider creditors' interests, what becomes of the usual formulation that it is the company to which all directors' duties are owed? To subscribe the creditors' interests as those of the company's, is to ignore significant other stakeholders, most notably shareholders. If it is posited that the duty is to consider creditors' interests amongst other interests, the issue becomes how those interests, which may very well be in opposition, be balanced? It appears the courts were moving towards a formulation that the weight accorded creditors' interests increased proportionately the closer the company got to insolvency. The issue of remedies is also pertinent. Sealy noted duty without a remedy was a nonsense.[383] However, the misfeasance action provided by section 301 of the 93 Act may well rebuff this attack. Indeed, despite the amorphous nature of the judicial commentary exposing the duty, the basic notion that creditors deserve to expect certain minimum levels of behaviour from the directors of their company debtors is commendable. To that end, though, it is superfluous to greater the statutory regime of creditor protection provided in the 93 Act.

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382 e.g. *Walker* v *Wimborne, Ring* v *Sutton, Kinsela, Grove* v *Flavel, Hilton, Permakraft, Neil, Winkworth, West Marcia,* discussed generally above Part II Section C - The Courts' Extension of Directors' Duties To Include Creditors.

383 Sealy-Monash, above n 91, p 177.

B The 93 Act's Duties and Its Greater Scheme For Preventing Director Misconduct

It has been suggested the 93 Act's express exposition of directors' duties is an innovation in New Zealand company law and to some extent this is true. However, reality is that New Zealand statute has for some time provided obligations upon directors in relation to their conduct, though under the less recognisable guise of provisions like section 320(1)(b) and 320(1)(a), respectively.

If anything, however, the duty provided in section 135 of the 93 Act is broader than its predecessor. When it applies has obviously expanded, but this, it is submitted, will not effect any substantive charge for creditors, as their means of remedy, section 301, is only applicable on the liquidation of the company. More importantly, the requisite degree of knowledge before liability will be imposed appears reduced by the use of "allow" in the new provisions. As to the other aspects of the sections, the adoption of "the" as opposed to "any" business of the company is unlikely to be interpreted by the courts due to the section's remedial nature, whilst the meaning of "substantial risk of serious loss" will have a ready proxy available in Bisson J's test from *Thompson* v *Innes* and the body of precedent developed under paragraph 320(1)(b) of the 55 Act.

Less perfect is the match between paragraph 320(1)(a) of the 55 Act and section 136 of the 93 Act. Identical comments as to when it applies can be made in respect of section 136 as for section 135. The charge from "debts" to "obligations" is potentially expansive, but it is yet to be seen whether the courts will be so inclined. The primacy of financial date in assessing the requisite ability or not for company performance of the obligation will arguably mean the section will predominantly focus still upon financial obligations. Similarly, case law decided under the 55 Act, such as *Petherick* and *Vinyl Processors* will continue to be relevant in applying the new sections. These parameters given, is there any room left, for the common law?

C *The Demise Of Redundant Judicial Sympathies*

The case supportive of the common law duty nigh invariably evidenced a range of director misconduct in order to illicit the judicial sympathies as to the plight of the creditors involved and the directors' obligations thereto. However, application of the various provisions available under the 93 Act to the cases' fact patterns, illustrates that in all instances when the deciding courts thought fit to impose liability (and it should be noted, not one did so on the basis of a breach of a directors' duty to creditors), the 93 Act would similarly impose liability.[384] As the law stands, it appears to give the courts ample scope to deal with the vast majority of potential director abuses of position without, to paraphrase Sealy, the need to invent any new cause of action based on phoney jurisprudential antecedents. The advent of the 93 Act, and sections 135 and 136 will allow for developments in this area to proceed on a statutory footing, properly integrated against the backdrop of corporate insolvency law as a whole. I this light, well meant but ill focussed dicta about directors' "duties" to creditors may be seen as both unnecessary and potentially pernicious. The demise of such redundant judicial sympathies appears complete.

384 See above Part IV - An Analysis Of The Continued Relevance Of the Common Law Duty Regarding Creditors: Does It Add Anything To The 93 Act?

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